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Re-Examining The Sham Doctrine: When Should An Overpayment Be Reflected In Basis?

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RE-EXAMINING THE SHAM DOCTRINE: WHEN SHOULD AN OVERPAYMENT BE REFLECTED IN BASIS?

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INTRODUCTION

Why would a prudent taxpayer make an acquisition at a price in excess of fair market value? This inquiry is critical to the determination of the taxpayer's basis in the asset acquired.

Burdensome tax brackets, coupled with the time-value of money, particularly crucial during periods of high interest rates, have induced taxpayers to seek "tax shelters" that provide deferral of their tax obligations. One type of scheme that offers benefits similar to those inherent in deferral is the acquisition of assets at inflated prices. The tax savings attributable to the overpayment — resulting from depreciation deductions and, where applicable, the investment tax credit — together with the income generated by the investment of the tax savings, can exceed the amount of the overpayment. It will be argued that where a taxpayer intentionally structures an overpayment for the sole purpose of securing tax savings and the related investment income, the overpayment should be treated as a sham and denied tax effect.

Taxpayers will frequently, though not always, use a nonrecourse note as the centerpiece of a transaction involving an overpayment. Where the nonrecourse note is substantially in excess of the fair market value of the acquired asset, it is probable that the entire transaction is devoid of economic purpose. It will be argued that, in these circumstances, the use of such a note should result in a zero basis — that is, the note and any cash investment, should be disregarded for purposes of taxation.

Not all overpayments, however, should activate the sham doctrine. Intentional overpayments must be distinguished from those that are engendered by erroneous assumptions of value. Taxpayers who mistakenly agree to pay an inflated price should not be pre-

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cluded by the sham doctrine from reflecting the entire purchase price, including the overpayment, in their basis computation. In addition, taxpayers occasionally make acquisitions at a price in excess of value in order to secure an additional benefit or service from the seller. The sham doctrine should not apply to such acquisitions. The appropriate tax treatment for the overpayment should be a function of the nature of the additional benefit or service secured.

Although the principal subject of this article is the sham doctrine, and not the likelihood-of-payment rationale that has evolved concerning nonrecourse notes, a cursory review of this rationale is an appropriate starting point.

I. THE LIKELIHOOD-OF-PAYMENT RATIONALE

The likelihood-of-payment rationale derives from the Supreme Court's analysis in *Crane v. Commissioner of Internal Revenue.*[1] For purposes of basis computations, the rationale requires classification of nonrecourse liabilities incurred in connection with the acquisition of an asset in accordance with the probability that the taxpayer will discharge the liability. The nonrecourse nature of a liability, though it may, in some circumstances, reduce the probability of payment, does not always mandate the exclusion of the liability from the basis computation. The rationale distinguishes those nonrecourse liabilities that are likely to be discharged from those that are not; only the former are properly reflected in basis.[2]

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1. 331 U.S. 1 (1947).

2. There is a limitation on the tax benefits attributable to nonrecourse debt even if the debt is includible in basis. I.R.C. § 465 provides that a taxpayer can only deduct losses to the extent that he is at risk. (Since a taxpayer who delivers a nonrecourse note is not considered to be at risk, § 465 circumscribes the tax benefits associated with the inclusion of the note in basis.) Real estate investments, however, are not subject to § 465. Moreover, the investment tax credit is computed by reference to basis without regard to the at-risk concept of § 465. *See* Treas. Reg. § 1-46-3(c)(1) (1979) and Rev. Rul. 80-235, 1980-2 C.B. 229. With respect, however, to property placed in service after February 18, 1981, the at-risk concept has been made applicable to the investment credit computation subject to certain exceptions. I.R.C. § 46(c)(8), as amended by The Economic Recovery Tax Act of 1981, § 211(f) Pub. L. No. 97-34, _ Stat. _ (1981) [hereinafter cited as The Economic Recovery Tax Act of 1981]. The application of § 465 may also be limited by virtue of its effective date. Thus, while § 465 has a significant role to play with respect to nonrecourse debt, there is still much tax benefit inherent in such debt provided that it is includible in basis.

A. *Market Value Greater Than Liability*

Where the fair market value of an asset is greater than the nonrecourse debt incurred upon its acquisition, there is sufficient likelihood of payment to warrant its inclusion in basis.[3] A taxpayer making such an acquisition will be motivated to discharge the debt in order to avoid forfeiture of the asset in a foreclosure proceeding. In *Crane*, the Supreme Court indicated that this motivation is a function of "the reality that an owner of property mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations."[4]

The rationale does not concern itself with the purchase price of the asset. As the Supreme Court indicated, so long as the fair market value of the asset is in excess of the encumbering debt, there is sufficient likelihood of payment regardless of the purchase price. Assume, for example, that a taxpayer purchases an asset with a fair market value of $100 by delivering to the seller $50 in cash and a nonrecourse note, secured by the asset, in the amount of $50. There is sufficient likelihood of payment to warrant inclusion of the note in basis inasmuch as it is highly likely that the taxpayer will discharge his obligation to pay the $50 on the note in order to retain the asset, which is worth $100; basis in these circumstances is equal to $100. Would the likelihood of payment be reduced if the taxpayer were to deliver to the seller the same nonrecourse note and $75 instead of $50 in cash?[5] Immediately after he delivered the cash and the note to the seller, and acquired the asset, the taxpayer is confronted with an asset (value of $100) which would be forfeited in a foreclosure proceeding if the $50 obligation were not discharged. Since, in both of the hypotheticals

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3. Nonrecourse debt, even if in compliance with the likelihood-of-payment rationale, is nevertheless excluded from basis if found to be contingent in nature. For a brief discussion of the contingency doctrine, *see* note 18 *infra*. Indeed, recourse debt, which need not comply with the likelihood-of-payment rationale in order to be reflected in basis, is, if contingent in nature, also excluded from the basis computation. *See* Landis, *Liabilities and Purchase Price*, 27 TAX LAW. 67 (1974).

4. 331 U.S. at 14. It should be noted, however, that this statement was made in the context of the Court's analysis of the taxpayer's amount realized and was not alluded to in the Court's discussion of basis. *See* Simmons, *Nonrecourse Debt and Basis: Mrs. Crane Where Are You Now?* 53 S. CAL. L. REV. 1, 39 (1979).

5. For an explanation of the factors which might motivate a taxpayer to make such an overpayment, *see* text & accompanying notes 51-62 *infra*.

posited, the relationship of the fair market value of the asset to the nonrecourse note is identical, the likelihood of payment is also identical, irrespective of whether the cash payment is $50 or $75 — once made, the cash payment is, in an economic sense, "lost" and thus is entirely irrelevant to the taxpayer's decision to pay on the note. In neither case does the likelihood-of-payment rationale preclude the inclusion of the nonrecourse note in basis. In sum, the amount of the cash payment and hence the purchase price is of no significance in the context of the rationale.[6]

B. *Market Value Equals Liability*

Where the fair market value of the asset is equal to the nonrecourse debt incurred upon its acquisition, one might conclude that, there being no equity to protect, the likelihood of payment is not sufficient to warrant including the liability in basis. *Crane,* however, rejected this notion, holding that such a nonrecourse debt is to be treated in the same manner as a nonrecourse debt that is less than the value of the encumbered asset.[7] In *Crane,* the taxpayer inherited real property which was subject to a debt that the taxpayer did not assume. The property's fair market value was equal to the amount of the encumbering liability. Despite the absence of any equity, the Court held that the taxpayer's basis was equal to the asset's fair market value — that is, the nonrecourse debt was includible in the basis computation. Thus, the Supreme Court concluded that sufficient likelihood of payment exists where the amount of the nonrecourse debt is equal to the asset's fair market value.

While *Crane* involved inherited property,[8] the courts and commentators have reached a similar conclusion in the context of property acquired by purchase.[9] In *Bolger v. Commissioner,*[10] the

6. *But see* Simmons, *supra* note 4, at 39, where the author suggests that the relationship of purchase price to market value is pertinent.

7. 331 U.S. at 9-11.

8. With respect to such property, basis is determined pursuant to I.R.C. § 1014.

9. I.R.C. § 1012 is the operative basis section with respect to property acquired by purchase. *Crane's* holding, to the effect that nonrecourse debt may, in the context of inherited property, be included in basis, has been extended to § 1012. *See* Blackstone Theatre Co. v. Commissioner, 12 T.C. 801 (1949); Mayerson v. Commissioner, 47 T.C. 340 (1966); Bolger v. Commissioner, 59 T.C. 760 (1973); Estate of Franklin v. Commissioner of Internal Revenue, 554 F.2d 1045 (9th Cir. 1976); Gibson Products Co. v. United States, 460 F. Supp. 1109 (N.D. Tex. 1978); Narver v. Commissioner, 75 T.C. 53 (1980); Adams, *Exploring the*

Internal Revenue Service (the Service) argued that a nonrecourse liability incurred in connection with the purchase of an asset should not be included in basis where the amount of the liability equals the fair market value of the property encumbered.[11] In such circumstances, the Service argued, the taxpayer has no incentive to discharge the debt and the likelihood of payment, therefore, is sufficiently minimal to warrant the exclusion of the debt from the basis computation. The Tax Court, rejecting this argument, concluded that the taxpayer had a sufficient motivation to discharge the debt such that inclusion of the debt in the basis computation was appropriate.[12] The motivation cited by the court consisted of two elements:[13] 1) each payment to be made in discharge of the liability would potentially create additional gain on the ultimate sale of the asset and refinancing possibilities; and 2) by continuing to make payments on the debt, the taxpayer would be able to retain the property and thereby enjoy any appreciation attributable to inflation or other factors.

Outer Boundaries of the Crane Doctrine: An Imaginary Supreme Court Opinion, 21 TAX L. REV. 159 (1966); Lurie, *Bolger's Building: The Tax Shelter That Wore No Clothes,* 28 TAX L. REV. 355 (1973); Simmons, *supra* note 4; McGuire, *Negative Capital Accounts and the Failing Tax Shelter,* 3 J. OF REAL ESTATE TAX. 439 (1976); Rev. Rul. 77-110, 1977-1 C.B. 58; Rev. Rul. 78-29, 1978-1 C.B. 62; Rev. Rul. 79-432, 1979-2 C.B. 289; Rev. Rul. 80-42, 1980-1 C.B. 182; Del Cotto, *Basis and Amount Realized Under Crane: A Current View of Some Tax Efforts in Mortgage Financing,* 118 U. PENN. L. REV. 69 (1969); Note, *Tax Shelters, Nonrecourse Debt, and the Crane Case,* 33 TAX L. REV. 277 (1978); Weidner, *Realty Shelters: Nonrecourse Financing, Tax Reform, and Profit Purpose,* 32 SW. L.J. 711 (1978); Posin, *Tax Shelters: The Continuing Struggle,* 6 HOFSTRA L. REV. 919 (1978).

10. 59 T.C. 760 (1973).

11. It has been suggested that this argument was foreclosed by the Supreme Court in *Crane.* Lurie, *supra* note 9, at 370. The Service, however, may have resurrected this argument in Rev. Rul. 79-432, 1979-2 C.B. 289. There, the Service asserted the position that where the entire purchase price is paid by the delivery of a nonrecourse note, it is appropriate to infer that the fair market value of the asset is less than the amount of the note. The inference is derived from the notion that a prudent seller would not sell an asset that could produce a given sum in cash in the marketplace for a nonrecourse note in the same amount. Applying the likelihood-of-payment rationale in this situation, the entire debt should be excluded from the basis computation. *See* text accompanying notes 14-35 *infra.* Unless the taxpayer is able to rebut this inference by establishing that the fair market value of the asset is at least equal to the amount of the nonrecourse note, the Service should prevail. *See also* Rev. Rul. 80-235, 1980-2 C.B. 229, where the Service, in concluding that a nonrecourse debt was not includible in basis, may have implicitly utilized this inference, although no reference was made to Rev. Rul. 77-110, 1977-1 C.B. 58; Rev. Rul. 78-29, 1978-1 C.B. 62; or the likelihood-of-payment rationale.

12. 59 T.C. at 771.

13. *Id.* at 770.

Both of these elements are concerned with the equity that arises after the acquisition of the property. It would seem that the Tax Court's reliance on these motivating factors is an appropriate reading of *Crane*. Although the *Crane* Court did not specifically articulate its reliance on such factors, it is apparent that the Court viewed them to be sufficiently significant to allow Mrs. Crane to include the nonrecourse liability, which was equal to the fair market value of the encumbered property, in her basis computation. Thus the *Bolger* court properly construed *Crane* as establishing the proposition that where the nonrecourse liability is equal to the fair market value of the assets, there is sufficient likelihood of payment to include the liability in basis.

C. *Liability Greater than Market Value*

With respect to nonrecourse debt that is in excess of the fair market value of the encumbered asset, the *Crane* Court, noting that the situation confronting it was different,[14] declined to express a view. Recent authorities indicate, however, that there is no likelihood of payment where nonrecourse debt is substantially in excess of the fair market value of the property. In *Estate of Franklin v. Commissioner*,[15] the court held that a nonrecourse debt incurred in connection with the acquisition of a motel was not includible in the basis computation, because the taxpayer failed to prove that the value of the motel was at least approximately equal to the amount of the debt. This failure of proof, in the court's view, required the conclusion that there was no likelihood of payment — only an imprudent taxpayer would discharge a nonrecourse debt in order to retain an asset with a value that is substantially less than the amount of the debt.

A similar situation arose in *Gibson Products Co. v. United States*,[16] where a partnership, of which the taxpayer was a member, purchased oil and gas leases and a contractual promise to drill certain test wells. In addition to a cash payment, the partnership paid for the wells and drilling contract by delivering a nonrecourse note in the amount of $660,000. After finding that the fair market

14. 331 U.S. at 12.
15. 544 F.2d 1045 (9th Cir. 1976).
16. 460 F. Supp. 1109 (N.D. Tex. 1979), *aff'd*, 637 F.2d 1041 (5th Cir. 1981).

value of the property securing the note was only $63,500,[17] the court held that no part of the note was includible in the basis computation.[18] The court's holding was premised on the likelihood-of-payment rationale:

> The basic underlying rationale of *Crane* is that a liability should be included in basis, even if the taxpayer has no personal liability because the taxpayer can be expected to satisfy the liability rather than lose the property. This assumption is true only if the property's value is equal to the amount of the debt. If the value of the property is less than the amount of the nonrecourse debt, it can not be assumed that the taxpayer will necessarily make full payment, or treat the liability as if it were his own.[19]

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17. The note was secured by the leases, certain operating equipment, and 80% of the income derived from the leases. *Id.* at 1112.

18. The court held, alternatively, that the note was not includible in basis by virtue of its contingent nature. Citing, *inter alia,* Lemery v. Commissioner, 52 T.C. 367 (1969) and Denver Rio Grande Western R.R. Co. v. United States, 505 F.2d 1266 (Ct. Cl. 1974), the court stated: "These cases hold that an obligation, which is too contingent and speculative, should not be included in cost basis, irrespective of the possible application of the *Crane* doctrine." 460 F.Supp. at 1115. Since the note would not be discharged in the absence of oil and gas production, the court concluded that the note was sufficiently contingent to bring it within the scope of the cited cases. The Fifth Circuit, in affirming, held that the contingent nature of the liability precluded the taxpayer from accruing the deduction and hence did not directly address the contingency question in the basis context.

The Service, in Rev. Rul. 80-235, 1980-2 C.B. 229, applied the contingency doctrine in determining whether a nonrecourse note secured by a commercially untested oil converter was includible in basis. It reasoned that, since the nonrecourse note would only be discharged if the converter generated income, the note was contingent. In reaching its conclusion, however, the Service failed to take into account that upon maturity of the note, there would be recourse against the converter in the foreclosure proceeding. The presence of this recourse against the converter distinguishes the ruling from *Gibson* where, as the court found, there was only recourse against the income inherent in the oil and gas production. Moreover, the Service's position, that the note was contingent upon the success of the converter and, therefore, not includible in basis, is inconsistent with Bolger v. Commissioner, 59 T.C. at 771 and Mayerson v. Commissioner, 47 T.C. at 353, 354. *But see Gibson,* 637 F.2d 1041, where the court (citing Fielder, *Drilling Funds and Nonrecourse Loans — Some Tax Questions,* 24 Sw. Legal Foundation Inst. on Oil & Gas Taxation 527 (1973)) suggested that *Mayerson* and *Bolger* should not apply — i.e., the contingency doctrine should be invoked — with respect to nonrecourse debt secured by assets subject to "sudden developments [that] might reduce the value of the property below the amount of the unpaid indebtedness." 637 F.2d at 1049 (brackets supplied by court). Nevertheless, the Service's holding, that the note was not includible in basis, perhaps is sustainable on a likelihood-of-payment analysis. *See* note 11 *supra.* Also, if the useful life of the converter had been shorter than the term of the note, the contingency doctrine would have been applicable, for, in these circumstances, there would only be recourse against the income generated by the converter. *See* Marcus v. Commissioner, 30 T.C.M. (CCH) 1263 (1971).

19. 460 F. Supp. at 1117. The Fifth Circuit noted, with approval, the District Court's likelihood-of-payment analysis, though it affirmed on a different ground.

The Tax Court, in *Narver v. Commissioner,*[20] recently engaged in the same analysis. There, the taxpayer purchased real property with a fair market value of not more than $412,000, at a price of $1,800,000.[21] The entire purchase price was paid by the delivery of a nonrecourse note. Relying on the likelihood-of-payment rationale, the court held that no portion of the note was includible in basis,[22] inasmuch as it would not have been reasonable to discharge a $1,800,000 nonrecourse obligation solely in order to retain property with a value of not more than $412,000.[23]

The Internal Revenue Service, relying on *Franklin* and *Crane,* utilized the likelihood-of-payment rationale in Rev. Rul. 77-110.[24] There, a partnership purchased film exhibition rights by delivering $200x and a nonrecourse note, secured by the film rights, in the amount of $1,800x. After first noting that the partnership was unable to "demonstrate that the fair market value of the acquired film rights at least approximated the amount of the nonrecourse obligation,"[25] the Service concluded that no portion of the nonrecourse note could be reflected in basis; the partnership's basis in the film rights was held to equal the amount of the cash payment, $200x.[26] The Service's holding was premised on its conclusion that it was not "reasonable from an economic point of view for [the partnership] to make a capital investment in the amount of the unpaid purchase price,"[27] since the value of the film rights was substantially less than the balance of the note. Indeed, a prudent taxpayer, in these circumstances, would certainly prefer to forfeit the asset in a foreclosure proceeding.[28]

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20. 75 T.C. 53 (1980).

21. *Id.* at 90.

22. *Id.* at 98.

23. *See* Hager v. Commissioner, 76 T.C. 759 (1981), where the court, relying on *Narver,* held that a nonrecourse debt that unreasonably exceeds the value of the encumbered asset is not includible in basis.

24. 1977-1 C.B. 58.

25. *Id.* Although the Service did not explicitly comment on the fair market value of the acquired film rights, it was indicated that the corporation from which the partnership had purchased the rights paid $200x for the rights just a few months before the resale to the partnership. One might, therefore, infer that the fair market value of the rights was approximately $200x.

26. For a discussion of this conclusion under the sham doctrine, *see* text & accompanying notes 145-59 *infra.*

27. 1977-1 C.B. at 59 (quoting *Estate of Franklin,* 544 F.2d at 1049).

28. The Service has made a similar analysis, comparing the amount of the nonrecourse debt with the value of the encumbered asset in order to determine likelihood of payment, in

These authorities, *Franklin, Gibson, Narver,* and Rev. Rul. 77-110, share two similarities. First, each of these authorities held that no portion of the nonrecourse debt was includible in basis. Although it has been suggested that where the nonrecourse debt is in excess of the value of the encumbered asset basis should equal the value of the asset,[29] the unanimous conclusion of these authorities that such a debt should be excluded from basis would appear to be sound.[30] To be sure, it would make little economic sense for a taxpayer to discharge his obligation on such a nonrecourse note to the extent of the fair market value of the encumbered asset, for, upon the cessation of payments on the note, the asset would nevertheless be lost in a foreclosure proceeding. Since, it would be imprudent for a taxpayer to make any payment on such a nonrecourse note, no portion of the debt should be includible in the basis computation.[31]

The second similarity shared by these authorities is the existence of a substantial disparity between the amount of the nonrecourse debt and the value of the encumbered asset. By virtue of this substantial difference, the courts and the Internal Revenue Service had no difficulty concluding that there was no likelihood of payment. What result should obtain, however, where the nonrecourse debt exceeds the value of the asset by only one dollar?[32] Presumably, a taxpayer would be as likely to discharge such a debt as he would be to discharge a nonrecourse debt exactly equal to the value of the asset. In fact, it has been properly concluded that the debt, in order to be includible in basis, need only approximate the value of the asset.[33]

The determination of the amount by which a taxpayer may structure a nonrecourse debt to exceed the value of the encumbered asset without adversely affecting the likelihood-of-payment

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Rev. Rul. 78-29, 1978-1 C.B. 62; Rev. Rul. 79-432, 1979-2 C.B. 289; Rev. Rul. 80-42, 1980-1 C.B. 182. *See also* Rev. Rul. 69-77, 1969-1 C.B. 59. *See* text & accompanying notes 176-202 *infra.*

29. *See* Adams, *supra* note 9, at 165; Del Cotto, *supra* note 9, at 73.

30. *But cf.* Posin, *supra* note 9, at 933, where the author suggests that with respect to real estate, nonrecourse notes should always be included in basis regardless of likelihood of payment.

31. For a further analysis, *see* Simmons, *supra* note 4.

32. *See* Adams, *supra* note 9, at 165, where the author poses this question.

33. *See* Estate of Franklin v. Commissioner, 544 F.2d at 1047-48; Rev. Rul. 77-110, 1977-1 C.B. 58; Rev. Rul. 78-29, 1978-1 C.B. 62.

analysis will turn upon a simple question: Given the value of the asset and the unpaid balance on the debt, would it be reasonable, from an economic perspective, for the taxpayer to discharge the debt?[34] The resolution of this question can only be made on a case-by-case basis.[35]

II. The Sham Doctrine

The conclusion that a nonrecourse note is not violative of the likelihood-of-payment rationale does not necessarily suggest that basis should equal the purchase price. Indeed, basis should not equal purchase price in any transaction, whether or not a nonrecourse note is involved — and, where a nonrecourse note is utilized, irrespective of the conclusion reached with respect to the

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34. *See* note 33 *supra*. In determining whether or not it is economically reasonable for a taxpayer to discharge a nonrecourse debt, it may be necessary to consider the rate of interest that the debt bears in relation to the prevailing rate in the marketplace for a comparable debt. For example, assume that a taxpayer is about to purchase an asset with a fair market value of $200 by delivering a nonrecourse note in the same amount and that 15% would be the appropriate rate of interest for such a note in the marketplace. If the taxpayer were to agree to deliver the $200 note, bearing interest at the rate of 15%, the note would be includible in basis, inasmuch as the value of the asset would equal the amount of the note. If, however, the note were structured to bear interest at the rate of 10% and the face amount of the note were increased above $200, in order to compensate for the lower interest rate, would a likelihood-of-payment analysis require that the note be excluded from basis? Although the note would now have a face amount in excess of the fair market value of the asset, the taxpayer, from an economic perspective, would be as likely to discharge such a note as he would be to discharge a $200 note bearing interest at 15%. In both cases, the taxpayer would have to pay the same number of dollars in order to retain the asset, although the composition of the dollars would be different — more interest and a compensating amount of less principal would be required by the 15% note. Thus, in both cases, the note should be includible in basis. For a discussion of whether the sham doctrine should apply where the face amount of a note is increased in order to compensate for a bargain interest rate, *see* text & accompanying notes 66-80 *infra*. For the computation of basis in such circumstances, *see* text & accompanying notes 81-92 *infra*.

35. *See* Simmons, *supra* note 4, at 46, where the author suggests that a variety of factors, such as the income that the property is expected to generate, may lead the court to a finding of economic reasonableness. *But see* Rev. Rul. 77-110, 1977-1 C.B. 58 and Rev. Rul. 78-29, 1978-1 C.B. 62, where the Service explicitly concludes that the focus should be on the relationship of market value to unpaid balance on the debt and implicitly suggests that the income that the property is expected to generate is only relevant as a factor in the determination of market value. The Service's view apparently rests on the notion that it would not be reasonable, economically, for a taxpayer to make the investment necessary to avoid foreclosure where the value of the asset is substantially less than the required investment. Indeed, in these circumstances, a prudent taxpayer who is anxious to secure the income inherent in the asset would take his capital to the marketplace and buy a comparable asset for a sum lesser than that required to avoid foreclosure.

likelihood-of-payment rationale — where a violation of the sham doctrine is found to exist.

A. *Background*

The sham doctrine has been applied in various contexts[36] for the purpose of separating those business transactions that the Internal Revenue Service is required to respect from those that are not entitled to deference. The doctrine, in effect, creates a threshold — all business transactions must, at a minimum, satisfy the doctrine's requirements or be disregarded for purposes of taxation. The Supreme Court has made clear that in order to pass this threshold a business transaction must be motivated, at least in part, by an economic objective.[37] Thus, taxpayers remain free to structure their business affairs for the purpose of tax avoidance, provided that non-tax (business) motivation is present as well.[38]

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36. *See, e.g.*, Knetsch v. United States, 364 U.S. 361 (1960); Higgins, Collector of Internal Revenue v. Smith, 308 U.S. 473 (1940); Gregory v. Helvering, C.I.R., 293 U.S. 465 (1935); Thompson v. Commissioner of Internal Revenue, 631 F.2d 642 (9th Cir. 1980); Bridges v. Commissioner of Internal Revenue, 325 F.2d 180 (4th Cir. 1963); Braddock Land Co. v. Commissioner, 75 T.C. 324 (1980); Morris v. Commissioner, 59 T.C. 21 (1972); Bixby v. Commissioner, 58 T.C. 757 (1972); Estate of Melcher v. Commissioner, 29 T.C.M. (CCH) 1010 (1970).

37. *See* Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Knetsch v. United States, 364 U.S. 361; Gregory v. Helvering, 293 U.S. 465.

The precise quantum of business purpose necessary in order to avoid the sham doctrine, an unresolved question for many years (*see* Rice, *The Judicial Techniques in Combating Tax Avoidance*, 51 MICH. L. REV. 1021, 1043-44 (1953)), has yet to be addressed by the Supreme Court. Perhaps, the necessary quantum of business purpose should bear a direct relationship to the magnitude of the tax benefit inherent in the transaction. *Cf.* ALI PROPOSALS FOR CHANGES IN THE RULES FOR TAXATION OF PARTNERS, Tent. Draft No. 3, at 108 (Mar. 27, 1979) (where it is suggested that in the partnership allocation context, there must be a balancing of the economic effect against the tax-reduction potential). *See also* Estate of Cohen v. Commissioner, 29 T.C.M. (CCH) 1221 (1970) (where the court indicated that interest is only deductible if the transaction presents more than "a slight or remote possibility of a profit. . . . " *Id.* at 1227.).

38. Although its impact is not clear, I.R.C. § 183, which proscribes deductions attributable to activities non-profit in nature, may be viewed as incorporating concepts similar to those inherent in the sham doctrine. *See* Jasionowski v. Commissioner, 66 T.C. 312 (1976); Weidner, *Realty Shelters: Nonrecourse Financing, Tax Reform and Profit Purpose*, 32 Sw. L.J. 711, 744 (1978). It would appear that whenever economic motivation is completely lacking such that the sham doctrine is applicable, § 183 would, a fortiori, be operative as well.

That is not to say, however, that the sham doctrine is applicable to all transactions that run afoul of § 183. In Hager v. Commissioner, 76 T.C. 759 (1981), the court indicated that the test for determining the applicability of § 183 is whether "the primary purpose and intention in engaging in the activity is to make a profit." *Id.* at 784. Hence, if the primary purpose for entering into a transaction is tax avoidance, § 183 will apply even though there

In *Higgins v. Smith*,[39] the Court explicated its concept of the sham doctrine.

> [T]he Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute.[40]

The notion that business transactions should be disregarded for tax purposes if they are "unreal or a sham" has become a fundamental principle of tax law.[41] The difficulty, however, arises when one undertakes the task of identifying those business transactions that fall within the scope of this classification.

Recently, in *Frank Lyon v. United States*,[42] the Supreme Court had an opportunity to clarify the contours of the classification process in the context of a sale-and-leaseback transaction. The Court concluded that the sale-and-leaseback format selected by the taxpayer should be respected for tax purposes — the taxpayer-lessor was held to be entitled to the depreciation deduction claimed.[43] Rejecting the government's invocation of the sham doctrine, the Court relied on a finding that non-tax objectives motivated, at least in part, the taxpayer's format selection.

> We emphasize that we are not condoning manipulation by a taxpayer through arbitrary labels and dealings that have no economic significance. Such, however, has not happened in this case.
>
> In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by

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is an ancillary profit motive. (Perhaps, however, a transaction that is principally motivated by tax-avoidance objectives can withstand the scrutiny of § 183 if, on an objective analysis, it is found to be supported by economic substance. For a discussion of the significance of economic substance to a sham analysis where tax reduction is the sole or principal motivation for entering into the transaction, *see* note 46 *infra.*) The sham doctrine, on the other hand, should not apply to such a transaction by reason of the presence of the subsidiary economic objective. *But see* Rice, *supra* note 37, at 1043-44. Section 183 may, therefore, be viewed as having a broader scope than the sham doctrine. Consequently, while a taxpayer may enter into a transaction that is principally motivated by tax-avoidance objectives without violating the sham doctrine, § 183 may, nevertheless, require that the transaction be subjected to its limitations.

39. 308 U.S. 473 (1940).
40. *Id.* at 477.
41. *See generally* cases cited notes 36-37 *supra.*
42. 435 U.S. 561 (1978).
43. *Id.* at 583-84.

business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.[44]

Approximately eighteen years prior to its decision in *Frank Lyon,* the Supreme Court, in *Knetsch v. United States,*[45] focused the sham doctrine on a taxpayer's claim that his indebtedness had sufficient substance to support an interest deduction. Disallowing the interest deduction on the rationale that the indebtedness constituted a sham, the Court was unimpressed by the District Court's finding that the taxpayer's motive for engaging in the transaction was tax avoidance. Rather, the Court's decision was a reflection of the taxpayer's failure to establish the existence of any business or economic objective for entering into the transaction. It was this lack of economic objective, not the mere existence of a tax avoidance purpose, that led to the Court's holding.[46] *Knetsch* estab-

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44. *Id.* The Court was obviously persuaded by the lessee-bank's difficulty, by virtue of state banking statutes and regulations, associated with owning the property that was the subject of the sale-and-leaseback; indeed, it was these "regulatory realities," explicitly mentioned in the Court's holding, which necessitated ownership of the property by one other than the lessee—such as the taxpayer. While the Court's analysis focuses on many factors, its linchpin is the non-tax (regulatory) need for one other than the lessee-bank to own the property. In addition, the Court was obviously persuaded by the economic benefits, from the taxpayer's viewpoint, that were inherent in the transaction. *See* Hilton v. Commissioner, 74 T.C. 305 (1980).

45. 364 U.S. 361 (1960).

46. Where a taxpayer is induced solely by tax-avoidance motives to enter into a transaction, the transaction will nevertheless be respected for tax purposes if it presents an opportunity for economic profit — i.e., if the transaction is supported by economic substance. *Cf.* Solomon, *Current Planning for Partnership Startup, Including Special Allocations, Retroactive Allocations, and Guaranteed Payments,* 37 N.Y.U. INST. FED. TAX. 13-1, 13-45 (1979). The *Knetsch* Court's emphasis on economic substance, rather than on tax-avoidance motive, was apparently designed to foster this proposition. The proposition is illustrated by the acquisition of a tax-sheltered investment for the sole purpose of enjoying the tax-reduction potential promised by the promoter. Although, from a subjective viewpoint, the taxpayer is interested only in tax-reduction and does not focus at all on the economic potential inherent in the investment, the transaction should nevertheless be given tax effect if an objective analysis of the investment indicates that it presents an opportunity for economic profit. A contrary conclusion would create significant administrative inconvenience inasmuch as it would require the tax authorities to engage in a subjective examination of the taxpayer's state of mind even where the transaction in question is, on an objective analysis, supported by economic substance. Thus, the sham doctrine should not be applied to a transaction that has economic substance, even if the taxpayer consummates the transaction solely in order to accomplish tax avoidance and without any business purpose. *But see* Estate of Cohen v. Commissioner, 29 T.C.M. (CCH) 1221.

On the other hand, transactions that are devoid of economic substance do not always

lished the definition of a sham: a transaction entered into solely for the purpose of tax reduction without any economic or commercial objective to support it.[47]

The Supreme Court has thus provided the analytical tools necessary for distinguishing sham transactions from transactions that have substance. In sum, a transaction will be respected for tax purposes, even if tax avoidance is a substantial motive for entering into the transaction, so long as it is also supported to some extent by business or economic objectives. Conversely, transactions that are motivated solely by tax avoidance[48] are classified as "unreal or

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constitute a sham. For example, a taxpayer who enters into a transaction that has no economic substance on the mistaken assumption that there is potential for economic profit should not be subjected to the penalty of the sham doctrine. For a further discussion of mistake, the policy consideration underlying the treatment of mistake and the administrative inconvenience inherent in such treatment, *see* text & accompanying notes 93-108 *infra*. In such cases, the presence of a non-tax motive, the desire to realize the profit potential, should secure recognition of the transaction for tax purposes. *Cf.* Dreicer v. Commissioner, ___ F.2d ___ (D.C. Cir. 1981), where the court concluded that I.R.C. § 183 is not applicable to a transaction that is motivated by the objective of securing a profit, even if there is no expectation a profit could be realized.

In effect, therefore, where a taxpayer seeks to avoid the sham doctrine by arguing that he mistakenly assumed that the transaction was supported by economic substance, a subjective examination of the taxpayer's state of mind is necessary. In contradistinction, a taxpayer who enters into a transaction for tax-reduction purposes only and seeks to avoid the sham doctrine by arguing that the transaction presents an opportunity for economic profit should be subjected to an objective analysis as to whether or not such an opportunity is present.

Although, therefore, the lack of a business purpose does not inexorably lead to the conclusion that economic substance is absent as well, it is assumed, for purposes of this article, that any transaction that is described as lacking business purpose is also devoid of economic substance. This assumption is made on the rationale that transactions described here as lacking business purpose, all of which involve the acquisition of assets at a price that the taxpayer knows to be in excess of fair market value solely in order to accomplish tax reduction, cannot be reasonably viewed, at least to the extent of such excess, as having economic substance.

47. The Fourth Circuit, in Bridges v. Commissioner, 325 F.2d 180 (4th Cir. 1963), reads *Knetsch* as follows:

> The Court in *Knetsch* held that the tax reduction motive or intent is immaterial in such cases and that the determinative question as to "whether what was done, apart from the tax motive, was the thing which the statute intended" is answered in the negative if it is apparent "that there was nothing of substance to be realized by [the taxpayer] from [the] transaction beyond a tax deduction." There the Court concluded that it was clearly apparent that "Knetsch's transaction . . . did not appreciably affect his beneficial interest except to reduce his tax." In view of such a finding, the Court held that the transaction was a sham.

Id. at 184 (citation ommitted) (brackets supplied by court). *See* cases cited note 36 *supra*.

48. It is assumed that, for purposes of this article, any transaction motivated solely by tax-avoidance objectives and, therefore, not supported by any business purpose does not

a sham"[49] and are disregarded for tax purposes.[50]

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have any economic substance. *See* note 46 *supra*.

49. Higgins v. Smith, 308 U.S. at 477.

50. The Second Circuit, in Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), concluded that a recourse debt incurred by a taxpayer in connection with the purchase of Treasury Notes was not a sham, even though the sole motivation for incurring the debt and entering into the transaction was to secure an interest deduction. The court found that it was not reasonably possible for the taxpayer to realize a profit on the transaction other than a tax savings. The court elucidated, to a limited extent, its rationale for rejecting the sham doctrine in a companion case, Barnett v. Commissioner, 364 F.2d 742 (2d Cir. 1966):

> We point out, as we did in *Goldstein*, that our discussion of a taxpayer's tax avoidance motives is only pertinent to Section 163(a). We do not hold that the existence of a tax avoidance motive, standing alone, is always, or even usually, sufficient to disallow a taxpayer the tax consequences he hopes for when he enters into a transaction.

Id. at 744, n.1. The factors that dissuaded the court from invoking the sham doctrine were: (1) the debt was recourse and the taxpayer, therefore, might very well sustain an economic loss; (2) the indebtedness was outstanding for a substantial period of time, and the taxpayer did, in fact, discharge his interest obligation during this time period; (3) the lenders were independent financial institutions; and (4) at least one of the notes could be accelerated, at the lender's will, after 30 days. The court did, however, sustain the disallowance of the § 163 deduction on the theory that such a deduction is only available where the interest obligation is incurred in a transaction motivated by economic objectives.

The court read *Knetsch* as establishing the requirement that interest, in order to be deductible pursuant to § 163, be incurred in a transaction that is economically motivated. In the Second Circuit's view, however, that is not to suggest that all transactions that are motivated solely by tax avoidance are shams. Whether the Second Circuit is prepared to incorporate this economic motivation requirement into other sections of the Code (such as § 1012) is unclear. One can only surmise that the *Goldstein* court did not perceive its economic motivation requirement as inherent in the code generally; for had that been its perception, there would not have been any need to suggest, as the court did, that the sham doctrine and the economic motivation requirement are distinct concepts which do not universally overlap.

Thus, the Second Circuit may require the presence of some element, in addition to a complete lack of economic motivation, before invoking the sham doctrine. *See also* Goodstein v. Commissioner of Internal Revenue, 267 F.2d 127 (1st Cir. 1959); Nassau Lens Co. v. Commissioner of Internal Revenue, 308 F.2d 39 (2d Cir. 1962); Brown v. United States, 426 F.2d 355 (Ct. Cl. 1970); Estate of Melcher v. Commissioner, 29 T.C.M. (CCH) 1010 (1970); Estate of Cohen v. Commissioner, 29 T.C.M. (CCH) 1221 (1970); Rothschild v. United States, 407 F.2d 404 (Ct. Cl. 1969); Wachovia Bank & Trust Co., N.A. v. United States, 499 F. Supp. 615 (M.D.N.C. 1980). Indeed, some commentators have questioned whether the interpretation of *Knetsch* that is offered in the text is the only reasonable one. Blum, *Knetsch v. United States: A Pronouncement on Tax Avoidance*, 1961 SUP. CT. REV. 135; Weidner, *Realty Shelters: Nonrecourse Financing, Tax Reform, and Profit Purpose*, 32 Sw. L.J. 711 (1978); Young, *The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAW. 275 (1969). Nevertheless, these authors would presumably apply, at least insofar as basis computation is concerned, I.R.C. § 183, the *Goldstein* doctrine, or, (in the context of depreciation deductions) the trade or business or production of income requirement of I.R.C. § 167 or § 168 to deny tax effect to a transaction which completely lacks a business or economic objective. It is the author's view, however, that the *Goldstein* approach is inconsis-

B. *Debt-Financed Acquisitions*

The sham doctrine is particularly important in the context of debt-financed acquisitions. Generally, when a businessman purchases an asset, he is anxious to negotiate the price downward. However, the same businessman might very well be inclined to negotiate the purchase price upward when the payment terms include the delivery of a note. This anomaly is engendered by a confluence of two factors: 1) high interest rates, and 2) high tax brackets.[51]

For example, assume that a taxpayer who is in a 70% income tax bracket[52] is about to purchase an asset, having a fair market value of $100 and a useful life of five years, for $100 in cash. Obviously the taxpayer's basis with respect to this asset would be $100, and the taxpayer would be able to enjoy depreciation deductions (assuming no salvage value) throughout the five year useful life of the asset in the aggregate amount of $100. What effect would be created if the taxpayer were to offer to deliver to the seller, in addition to $100 in cash, a recourse note in the amount of $100, payable, without interest, ten years from the date of purchase? If the taxpayer were permitted to include the amount of the note in his basis computation, he would realize a greater profit[53] from the transaction than if he had only paid, as the purchase price, $100 in cash; this would be true even if the taxpayer is compelled to make full payment on the note. Assuming that the taxpayer deducts as depreciation 20% of basis in each year of the five year life of the

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tent with *Knetsch* itself, with the Fourth Circuit's interpretation of *Knetsch* in *Bridges*, 325 F.2d 180, and with the reading of *Knetsch* recently expressed by the Tax Court. *See Braddock*, 75 T.C. 324. Moreover, the viability of this approach, in light of *Frank Lyon*, is certainly questionable.

Finally, as a matter of policy, a taxpayer who, without any non-tax objective, enters into a transaction that is devoid of economic substance should not be permitted to enjoy the tax benefit inherent therein. *See* text & accompanying notes 127-28 *infra*.

51. *See* McKee, *The Real Estate Tax Shelter: A Computerized Expose*, 57 VA. L. REV. 521 (1971).

52. Of course, commencing with taxable years beginning in 1982, the maximum tax bracket has been reduced to 50%. I.R.C. § 1, as amended by the Economic Recovery Tax Act of 1981, § 101(a). It should be noted, however, that a dollar of investment in 1982 or later may nevertheless generate more than 50 cents of tax savings by virtue of the availability of tax credits.

53. It should be noted that if the note were interest bearing, this profit would diminish and I.R.C. § 265 might well have application. On the other hand, if the investment tax credit were applicable, this profit would increase.

asset and assuming that tax-free investments are available at an interest rate of 10%, the taxpayer would realize the following amounts by virtue of the utilization of debt to "overpay" for the asset:

TABLE I

	Column I Additional depreciation deduction generated by virtue of the note[54]	Column 2 Tax Savings (70% of Col. 1)	Column 3 Interest income generated by tax savings[55]
Year 1	20	14	
Year 2	20	14	1.40
Year 3	20	14	2.94
Year 4	20	14	4.63
Year 5	20	14	6.50
Year 6			8.55
Year 7			9.40
Year 8			10.34
Year 9			11.38
Year 10			12.51
TOTAL	$100	$70	$67.65

In this example, the taxpayer would realize $137.65, the sum of the tax savings ($70) and the interest income generated by the tax savings ($67.65), by virtue of the addition of the note and its inclusion in basis. Since the taxpayer, in year 10, is required to discharge his $100 obligation on the note, the taxpayer would enjoy

54. Since depreciation is deducted at the rate of 20% of basis per year, the inclusion of the $100 nonrecourse note in basis will generate a $20 deduction in each year of the five year life.

55. This column contains the amounts of interest income that will be generated by investing the tax savings (Column 2) in a 10% tax-free bond. It is assumed that no interest income will be earned during year 1, inasmuch as the deduction will not generate any cash savings until the filing of the tax return after the year's expiration. In year 2, however, interest income in the amount of $1.40 will be earned with respect to the $14 of tax savings generated in year 1. In year 3, interest income in the amount of $2.94 will be earned with respect to the sum of tax savings generated in years 1 and 2 ($28) and the interest income earned during year 2 ($1.40) will now also be available to earn interest. In effect, compounding is assumed to be on an annual basis. In each succeeding year, interest is similarly computed by reference to the sum of the aggregate amount of savings generated in previous years, and the aggregate amount of interest income earned in those years. As the foregoing makes apparent, the obligation to pay tax during the course of the year on an estimated basis is disregarded.

an after-tax profit of $37.65 ($137.65-$100) by reason of paying $100 more than requested for the asset.[56]

If the note were nonrecourse,[57] the taxpayer might enjoy an even greater profit.[58] In year 10 he would have two options: If the taxpayer were anxious to retain the asset, he would make the $100 payment on the nonrecourse note in which case he would realize the same after-tax profit, $37.65, as if the note had been recourse. If, on the other hand, the asset were no longer of sufficient value to the taxpayer, he might well decide not to discharge the obligation and would therefore forfeit the asset in which case the taxpayer would enjoy an after-tax profit in excess of $37.65.[59] In sum, the taxpayer would realize an after-tax profit of at least $37.65, and perhaps even more, by increasing the purchase price $100.

With a full appreciation of the tax consequences of such an increase in purchase price, a prudent businessman would certainly be inclined to add a substantial note to the purchase price of

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56. An additional benefit inherent in this arrangement is that, by reason of inflation, the payment of $100 in year 10 will be made with cheaper dollars than the dollars generated in earlier years by the tax savings and related investment income attributable to the overpayment.

57. For a discussion of the benefits of leverage inherent in such a note, *see* Young, *The Role of Motive in Evaluating Tax-Sheltered Investments,* 22 TAX LAW. 275 (1969).

58. I.R.C. § 465, if applicable, would certainly act as a limitation with respect to depreciation deductions engendered by the inclusion of the nonrecourse note in basis. It is assumed here, however, that § 465 is inapplicable, either because the asset purchased is real property or the transaction occurred prior to the enactment of § 465. It should also be emphasized that the basis computation remains significant, in the investment tax credit context, despite the enactment of § 465. Treas. Reg. § 1.46-3(c)(1) (1979). For example, if the nonrecourse note is included in basis in the hypothetical posited here, the investment tax credit, which is equal to 10% of the basis, would be equal to $20, even though the taxpayer is only at risk for $100. *But see* note 2 *supra.*

59. If the taxpayer were to abandon the property and not discharge the note, a tax liability in the amount of $70 would be generated in year 10, the year of abandonment; the amount realized would be $100, which is the amount of the liability (*see* Millar v. Commissioner of Internal Revenue, 577 F.2d 212 (3d Cir. 1978); Freeland v. Commissioner, 74 T.C. 970 (1980); Simmons, *Nonrecourse Debt and Amount Realized: The Demise of Crane's Footnote 37,* 59 OREGON L. REV. 3 (1980)), and the basis would be zero. *But see* Tufts v. Commissioner, _ F.2d _ (5th Cir. 1981), where the court held that nonrecourse debt is included in amount realized only to the extent of the fair market value of the encumbered asset. The tax liability of $70 is computed on the assumptions that the entire $100 gain is ordinary income (recapture) and the taxpayer is in the 70% tax bracket in year 10. Thus, if the taxpayer were to abandon the property, he would realize an after-tax profit of $67.65 by virtue of the addition of the nonrecourse note— $137.65 of tax savings and interest less the tax liability of $70 in year 10. If the note were excluded from computation by virtue of either the likelihood-of-payment rationale or the sham doctrine, the note could similarly be excluded from amount realized upon foreclosure. Treas. Reg. § 1.1001-2(a)(3) (1980).

most[60] of the assets that he acquires.[61] The crucial question posed by this arrangement is whether the note constitutes a sham and therefore should be disregarded for tax purposes. The resolution of this question should turn, in large part, upon whether the purchase price is in excess of the fair market value of the asset to be acquired; for if the purchase price of an asset is equal to its fair market value, sufficient business motivation is present to avert invocation of the sham doctrine. That is not to say, however, that a sham transaction is present whenever the purchase price of an asset exceeds its fair market value; in this circumstance, further inquiry is necessary in order to determine the propriety of invoking the sham doctrine.[62]

C. *Why Overpay?*

A taxpayer's willingness to pay more for an asset than its fair market value is explainable on one of three grounds: 1) the taxpayer mistakenly assumes that the fair market value is equal to the purchase price; 2) the seller of the asset provides the taxpayer with some benefit in addition to the asset; or 3) the taxpayer is induced to effect the transaction by the tax-avoidance possibilities presented.

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60. Obviously, the acquisition of some assets, such as assets that are not depreciable, would not be the appropriate subject for the addition of such a note, inasmuch as the basis increase attributable to the note, in the case of the non-depreciable asset, would not generate any deductions.

61. Another variation on the concept of inflating purchase price in order to secure tax reduction was recently addressed by the Internal Revenue Service in Rev. Rul. 81-149, 1981-1 C.B. _ (Internal Revenue Bulletin 1981-21, May 26, 1981). There, a corporate taxpayer secured services for a fee of $20,000. One half of the fee was paid in cash, and the other half was paid by the delivery of a 50-year note, bearing interest at 1.67% compounded monthly. Interest and principal were required to be paid upon maturity of the 50-year note. Stating that a service provider would not ordinarily accept a 50-year note in payment for its services, the Service found that the "actual fee" for the services was limited to the amount of the cash payment. Thus, since delivery of the 50-year note was motivated by tax-reduction purposes only, interest accruing thereon was held not to be deductible.

62. *See* Union Bank v. United States, 285 F.2d 126 (Ct. Cl. 1961), where the court noted:

> The fact that a purchaser of an asset pays more for it than it is worth does not, of itself, convert the sale into something other than a sale, for tax purposes. It may, at the most, suggest to a diligent tax collector that the transaction may have other features which belie its appearance.

Id. at 128. *Accord* Narver v. Commissioner, 75 T.C. 53 (1980), where the court stated: "[W]e do not mean to imply that a sale will be disregarded for tax purposes merely because the purchaser pays too much." *Id.* at 102.

Whenever a taxpayer willingly pays more for an asset than its fair market value solely in order to accomplish tax reduction, the sham doctrine should preclude the taxpayer from enjoying a basis in excess of the asset's fair market value.[63] On the other hand, where a taxpayer mistakenly pays more than fair market value for an asset, the sham doctrine has no role to play, for the taxpayer is motivated to pay the inflated purchase price by business or economic objectives. In such a situation, the taxpayer's perception is that the seller will not sell the asset for a lesser price and that business realities compel him to pay the price requested. Finally, a taxpayer who pays more than fair market value for an asset in order to secure some additional benefit from the seller should not be subjected to the sham doctrine since the taxpayer is motivated by business or economic objectives; he is paying a fair consideration for the asset and the other benefit he secures. However, an allocation will be required so that the taxpayer's basis for the asset purchased will equal the portion of the consideration that is attributable to the asset. The portion of the consideration that is furnished by the taxpayer in order to secure the additional benefit will, for tax purposes, be reflected appropriately.[64]

Superimposing these principles upon the hypothetical posed previously yields the following analysis with respect to the appropriate tax treatment of the $100 recourse note. The taxpayer in the hypothetical did not make any mistake concerning the fair market value of the asset. Indeed, the seller offered to sell the asset for $100 in cash, and the taxpayer responded by offering to pay $100 in cash and $100 in a note. Nor did the taxpayer receive any additional benefit from the seller that induced the addition of the note to the purchase price. Thus, it is fair to conclude that the sole motivation for the taxpayer's introduction of the note was his desire to obtain the after-tax profit of $37.65 generated by tax deductions

63. *See, e.g.*, Morris v. Commissioner, 59 T.C. 21 (1972); Bixby v. Commissioner, 58 T.C. 757 (1972); Decon v. Commissioner, 65 T.C. 829 (1976). *See also* text & accompanying notes 126-202 *infra*.

64. If, for example, the taxpayer pays $200 for an asset that has a fair market value of $100 in order to secure a service from the seller, the taxpayer would be entitled to a basis with respect to the asset of $100 and would be entitled to a $100 deduction pursuant to I.R.C. § 162 (assuming the requirements of this section are satisfied). If, on the other hand, the taxpayer were to purchase such an asset (fair market value of $100) for $200 from his son without receiving any additional benefit from his son, the taxpayer would be entitled to a basis of $100 and would be deemed to have made a gift of $100.

and interest income produced by the tax savings.[65] Inasmuch as the taxpayer added the note to the purchase price solely in order to obtain this tax benefit, the sham doctrine requires that the note be disregarded and that basis be limited to $100.

D. *Equality of Consideration*

The threshold question, in determining the applicability of the sham doctrine in the basis computation context, is whether the price exceeds the fair market value of the asset acquired; it is only where such an excess is present that the sham doctrine is potentially operative. The Tax Court, in *Brountas v. Commissioner,*[66] recently confronted this question. In *Brountas,* a limited partnership delivered cash and a nonrecourse note[67] to an entity engaged in the oil and gas business as an operator[68] in return for: 1) oil, gas or mineral leasehold interests and 2) an agreement to drill a test well. The partners sought to deduct their share of the partnership's intangible drilling and development costs.[69] One of the contentions advanced by the Internal Revenue Service was that the nonrecourse note was a sham and should, therefore, be disregarded for tax purposes.[70] The court, however, rejected the government's

65. As previously discussed (*see* text & accompanying notes 54-60 *supra*), the taxpayer, in the nonrecourse context, might obtain an even greater after-tax profit if he decides not to discharge the obligation.

66. 73 T.C. 491 (1979).

67. The partnership borrowed cash from the operator on a nonrecourse basis. Then, the partnership redelivered the borrowed cash to the operator in payment for the leasehold interests and the agreement to drill. The court concluded that this borrowing and repayment format had no substance; in essence, the partnership delivered cash and a nonrecourse note in order to obtain the leasehold interest and the agreement to drill. 73 T.C. at 533.

68. The court defined operator as follows:

> An operator is an entrepreneur who attempts to locate and obtain oil and gas prospects. Initially, an operator's geological staff searches for geographical areas beneath the surface of which may exist oil and gas reserves in commercial quantities. These areas are called prospects. The operator then attempts to obtain leasehold rights to these mineral interests by negotiating with either the landowner or other owners of the mineral rights. Once the operator has obtained the mineral leasehold rights, and has decided to drill on the prospect, the operator usually attempts to bring in venture capital partners for the drilling.

73 T.C. at 495.

69. I.R.C. § 263(c) and Treas. Reg. § 1.612-4 (1965) authorize an election to currently deduct such costs.

70. If the nonrecourse note had been a sham, a disallowance of the intangible drilling and development deduction would have been appropriate, inasmuch as no "expenditure" would have been "incurred," within the meaning of Treas. Reg. § 1.612-4 (1964). 73 T.C. at

argument, concluding that the sham doctrine is inapplicable where a taxpayer acquires an asset for a price that approximates fair market value.

> These transactions were carefully structured so that the entire package of compensation which flowed from the investors to the operators was within a reasonable range of commercial practice in light of the obligations which the operators assumed. We conclude that one part of this package — the nonrecourse notes — cannot properly be picked out of these transactions and be labeled a sham, as that piece provided a necessary part of the consideration which the operators received. To be sure, CRC [the general partner] structured those arrangements to provide tax shelter, and intended that the nonrecourse notes would yield benefits to the investors in the limited partnerships, but there were sound economic reasons for the use of such obligations in these transactions.[71]

In another portion of its opinion, the court stressed the presence of arm's-length negotiations:

> We have found, contrary to respondents' contention, that the nonrecourse notes which the investors gave to the operators had economic significance and were a bona fide and bargained for part of these transactions. These transactions were integrated wholes. The specific bundle of rights which each operator received was arrived at through arm's-length negotiations between the operators and CRC [the general partner], and the terms of the resulting contractual agreements were within a reasonable range of commercial practice.[72]

The inclusion of arm's-length negotiation as a pertinent factor in the court's analysis does not alter the basic notion that the sham doctrine is inapplicable whenever a taxpayer acquires an asset at a price that is approximately equivalent to its fair market value.[73] In

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576. An additional consequence of invoking the sham doctrine would have been a reduced basis for each of the partners with respect to their partnership interest, since disregarding the nonrecourse note would have prevented application of I.R.C. § 752(a). This section authorizes, in effect, an increase in a partner's basis in his partnership interest in an amount equal to his proportionate share of the increase in partnership liabilities. Inasmuch as a partner may not deduct, as his share of partnership loss, an amount in excess of his basis in his partnership interest (I.R.C. § 704(d)), characterization of the nonrecourse note as a sham would have, in effect, reduced the amount of proportionate loss available as a deduction to each partner.

71. 73 T.C. at 545.

72. 73 T.C. at 540-41.

73. *But see* Collins v. Commissioner, 54 T.C. 1656 (1970), where the court applied the sham doctrine even though the value of the consideration package given by the taxpayer to the seller was equal to the value of the asset the taxpayer received in the transaction. The court held that the amount labelled by the taxpayer as prepaid interest was, in substance, a part of the purchase price — not deductible as interest and presumably includible in basis.

fact, in other contexts, it has been held that where fair market value is selected as the purchase price, the parties to the transaction are deemed to be acting at arm's-length even though they are related.[74] Thus, the court's conclusion that the purchase price, which consisted of cash and a nonrecourse note, was approximately equivalent[75] to fair market value, was determinative — the court's observation concerning the presence of arm's-length negotiation, properly viewed, was merely an inference derived from its conclusion relating to fair market value equivalency.

In making its analysis as to the equivalency of fair market value and purchase price, the court indicated that it was not necessary for it to consider whether the sum of the cash and the face amount of the nonrecourse note delivered to the operator by the partnership exceeded the fair market value of assets or rights acquired from the operator.[76] In the court's view, so long as cash plus the fair market value of the nonrecourse note approximately equals the fair market value of assets or rights acquired by the partnership, the sham doctrine in inapplicable.[77] In other words, when making the equivalency analysis in order to determine the propriety of invoking the sham doctrine, the fair market value,[78] and not the face amount, of the nonrecourse note must be taken into

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In the author's view, the court's recharacterization of the prepaid interest, although explicitly premised on the sham doctrine, is only supportable on a substance over form theory. The court's failure to discern the differences between these doctrines is, perhaps, understandable, inasmuch as commentators suggest that the substance over form doctrine and the sham (or business purpose) doctrine are frequently difficult to distinguish and occasionally confused by the courts. *See* Bittker, *Persuasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 HOWARD L.J. 693, 722 (1978); Rice, *supra* note 37, at 1041-48; Note, *The Business Purpose Doctrine: The Effect of Motive on Federal Income Tax Liability*, 49 FORDHAM L. REV. 1078, 1080 (1981).

74. *See* King v. United States, 545 F.2d 700 (10th Cir. 1976).

75. The equivalence need not be exact. Provided that the purchase price is within a "range of reason," the sham doctrine is inapplicable. Curry v. Commissioner, 43 T.C. 667, 694 (1965); Royal Farms Dairy Co. v. Commissioner, 40 T.C. 172, 185 (1963).

76. The court stated:

> In order to decide the sham issue, we did not need to go farther and decide whether, as petitioners contend and numerous witnesses testified, the 150-percent markup for the no-out turnkey obligation [the operator's profit element with respect to the agreement to drill] would have been commercially fair if represented by cash rather than a contingent obligation [the nonrecourse note].

73 T.C. at 541-42, n.48.

77. *Id.* at 541-42.

78. Of course, a determination of the note's fair market value will be a function of the note's contingent nature.

account.[79]

For example, assume that a taxpayer purchases an asset with a fair market value of $150 by delivering cash of $100 and a nonrecourse note with a face amount of $75. If, after taking into account the fact that the taxpayer is not legally obligated to discharge the debt, it is determined that the note has a fair market value of not more than $50, the note's validity should be sustained. The rationale for focusing on the fair market value of the note, rather than its face amount is that the note is only economically significant to the seller to the extent of its fair market value. That is, the seller, in this hypothetical, would be anxious to make certain that he receive a package of consideration with a fair market value at least equal to the fair market value of the asset being sold. Thus, if it is assumed that the fair market value of the $75 nonrecourse note, after taking into account its contingent nature, is $50, it is apparent that the seller would refuse to sell his $150 asset for any amount less than the $100 in cash and the $75 nonrecourse note. The taxpayer's willingness to provide the seller with this consideration package is obviously motivated by business objectives — a reduction in the amount of the consideration package offered by the taxpayer would precipitate a forfeiture of the opportunity to acquire the asset. By virtue of the equality of the fair market value of consideration exchanged by the taxpayer and the seller, the sham doctrine is inapplicable.[80]

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79. *See* Gyro Engineering Corp. v. United States, 417 F.2d 437 (9th Cir. 1969), where the court indicated that the terms of payment should be taken into account in determining whether or not an overpayment is present.

80. This analysis, which focuses on the fair market value of the consideration package, rather than the face amount, has recently been adopted by the Internal Revenue Service in Rev. Rul. 79-432, 1979-2 C.B. 289. There, the taxpayer purchased an art tax shelter for $200,000 — $30,000 in cash and a $170,000 nonrecourse note (although the note was in form partially recourse, the Service concluded that a limitation upon the obligee's rights in the event of default required, as a matter of substance, a nonrecourse characterization). Though the shelter's promoter provided two appraisals to the effect that the fair market value of the shelter's estimated revenues approximated $200,000, the Service concluded that the fair market value of the assets acquired from the promoter was only $30,000. In determining that the $170,000 note was not properly includible in basis, the Service relied on its finding that the value of the consideration package supplied by the taxpayer exceeded the value of the assets acquired:

> [T]he liability created by a nonrecourse note given as a part of the purchase price of property cannot be included in the basis of the property where the value of the property cannot be shown at least to approximate the *value of the consideration*, including the amount of the note.

E. *Discount: Interest or Includible in Basis?*

In those cases where equality of consideration is present, the focus of the inquiry must shift to the computation of basis. Stated in terms of the hypothetical under examination, the crucial question is whether the taxpayer's basis for the asset acquired is $150, the fair market value of the consideration package delivered to the seller, or $175, the sum of the cash and the face amount of the note. While the resolution of this question remains unclear,[81] it is suggested that the taxpayer's basis should be $150. Assuming this position is correct, what is the appropriate characterization of the $25 difference between the $150 basis and the $175 amount the taxpayer will actually be required to pay in order to retain the asset? Since the seller would obviously have accepted $150 cash in payment for the asset, instead of $175 on a deferred basis, the $25 difference between cash price and deferred price represents compensation to the seller for the use of his capital. As such, this $25 differential should be characterized as interest, for which a deduction should be available to the taxpayer[82] in the taxable year for

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Id. at 291 (citations omitted) (emphasis supplied).

The ruling is also noteworthy for its assertion that:

> It is readily apparent that if the items purchased from the sales promotion corporation had a fair market value approaching $200,000, the sales promotion corporation would not have made such items available for sale to the public on the highly speculative terms described above.

Id. at 290.

Thus, it would appear that, in the Service's view, the presence of a nonrecourse note can in itself imply that the note's fair market value is less than its face amount. *See* note 11 *supra.* Such an implication, while perhaps appropriate in the context of the ruling's facts, is not a universal truth. For example, if a taxpayer were to purchase an asset (having a fair market value of $100) for $99 in cash and a nonrecourse note with a face amount of $1, bearing interest at a reasonable rate, one could not reasonably argue that the fair market value of the asset is less than $100.

81. *See* Simmons, *supra* note 4, at 28.

82. The Supreme Court, in Commissioner v. National Alfalfa Dehydrating & Mill Co., 417 U.S. 134 (1974), indicated that, in determining whether or not an item constitutes interest within the meaning of I.R.C. § 163, "the relevant inquiry in each case must be whether the issuer-taxpayer has incurred, as a result of the transaction, some cost or expense of acquiring the use of capital." *Id.* at 147. Moreover, in United States v. Midland-Ross Corp., 381 U.S. 54 (1965), the Supreme Court made the following observation with respect to discount — the difference between the face amount of an obligation and the cash received therefor: "this Court has often recognized the economic function of discount as interest." *Id.* at 66 (footnote omitted). *See* Gyro Engineering Corp. v. United States, 417 F.2d 437 (9th Cir. 1969); Roemer v. Commissioner, 69 T.C. 440, 461 (1977), *aff'd,* Holgerson v. Commissioner, 638 F.2d 104 (9th Cir. 1981). *But see* Mayerson v. Commissioner, 47 T.C. 340 (1966); Kingsford Co. v. Commissioner, 41 T.C. 646, 659 (1964).

which it is paid or incurred,[83] and should not be included in basis.[84]

The characterization of this $25 difference as interest is consistent with the Internal Revenue Service's initial announcement on the subject. In Treasury Office Decision 959,[85] an individual taxpayer purchased an asset by delivering a note to the seller. The fair market value of the asset purchased was less than the face amount of the note. The Service held that: 1) the difference between the face amount of the note and the fair market value of the asset acquired constituted discount, deductible as interest during the life of the note; and 2) the basis of the asset acquired by the taxpayer was equal to the asset's fair market value.

Although the conclusions reached in the Treasury Office Decision seem to reflect the economic reality of discount as interest, properly precluding the inclusion of such discount in the basis of the asset acquired, the Internal Revenue Service has maintained a contrary position in the courts. For example, in *American Smelting & Refining Co. v. United States,*[86] the Service argued that the concept of discount and, impliedly, the principles inherent in the concept — deductible interest and omission of the discount from the basis computation[87] — are not applicable unless the note or obligation is issued for cash.[88] The Supreme Court, observing a

83. I.R.C. § 461.

84. It must be noted that at least in the context of nonrecourse debt, the Treasury will be adversely affected by this approach. The effect of recognizing the discount as interest deductible over the life of the debt, and, therefore, omitting it from the basis computation, in the context of a nonrecourse debt that is not contingent (*see* note 18 *supra*), is to prevent the depreciation of the discount over the useful life of the asset — instead, the discount must be deducted over the life of the debt which may be shorter, but certainly not longer, than the useful life of the asset. The Treasury, however, will enjoy offsetting revenue by virtue of the inapplicability of the investment tax credit with respect to discount that is treated as interest.

85. 4 C.B. 129 (1921).

86. 130 F.2d 883 (3d Cir. 1942).

87. Those courts that have held that the difference between the face amount of an obligation and the fair market value of the asset acquired therefor does not constitute discount (deductible interest) have done so on the rationale that the basis of the asset acquired should equal the face amount of the obligation — any gain or loss arising from the issuance of the obligation in exchange for the asset should be recognized upon the sale or exchange of the asset. *See, e.g.,* Montana Power Co. v. United States, 232 F.2d 541 (3d Cir., *en banc,* 1956), *cert. denied,* 352 U.S. 843 (1956); Dodge Bros., Inc. v. United States, 118 F.2d 95 (4th Cir. 1941); Sacramento Medico Dental Building Co. v. Commissioner, 47 BTA 315 (1942); Sam H. Harris Theatrical Enterprises, Inc. v. Commissioner, 2 T.C.M. (CCH) 308 (1943).

88. *See* 130 F.2d at 885.

conflict in the lower courts,[89] found it unnecessary to decide this question: "[T]his Court has never decided the question whether discount may result when debt obligations are issued in exchange for property other than cash. Those courts that have passed upon the issue have reached opposing conclusions."[90]

While the Internal Revenue Service has vacillated and the Supreme Court has not decided the question, it is suggested that the preferable view is that discount be treated, in accordance with economic reality, as interest[91] and thus be excluded from the basis computation.[92]

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89. *Compare* Nassau Lens Co. v. Commissioner, 308 F.2d 39 (2d Cir. 1962) *and* American Smelting and Refining Co. v. United States, 130 F.2d 883 (3d Cir. 1942) *with* Southern Natural Gas Co. v. United States, 412 F.2d 1222, 188 Ct. Cl. 302 (Ct. Cl. 1969) *and* Montana Power Co. v. United States, 141 Ct. Cl. 620, 159 F. Supp. 593, *cert. denied,* 358 U.S. 842 (1958).

90. Commissioner v. National Alfafa Dehydrating & Milling Co., 417 U.S. 134, 146 (1974) (citations omitted).

91. Holding that discount must be recognized for tax purposes as such, even where it is created in the context of the exchange of a note or obligation for an asset other than cash, Mr. Justice Marshall (then Circuit Judge Marshall), in Nassau Lens Co. v. Commissioner, 308 F.2d 39 (2d Cir. 1962), said:

> It may well be true that to a "borrowing buyer" interest or discount payments seem part of the cost of the property. In reality, however, they are the cost of using the money which is needed to purchase the property, a cost not incurred by the buyer with ready cash. This distinction is clearly recognized by the Code, and we feel we must give effect to it. Surely a promise today to pay $150,000 in ten years is not presently worth $150,000 either in property or cash. And since the debentures here could be redeemed at various times for various amounts, the cost of the property could not be determined until the redemption and that might not occur until long after the property had been resold. The contention asserted is merely that when a seller also becomes a financing medium by taking bonds issued at a discount instead of cash in exchange for property, the tax laws will not recognize a charge for the use of money. We find no support for such an assertion and we reject it.

Id. at 44 (footnote and citation omitted).

92. It must be noted that Congress' perception of discount, prior to the enactment of I.R.C. § 483, may be viewed as inconsistent with the resolution suggested here. In explaining the need for the enactment of § 483, the Senate Finance Committee indicated its understanding of the treatment of discount under the then existing law:

> (a) *Present law.*— Under present law, an individual may sell a capital asset on the installment basis without making any specific provisions for interest payments on installments. . . . The buyer takes as a basis for the property the total sales price paid. For example, an individual taxpayer might sell a capital asset worth $1,000 for $1,300 payable over 10 years. . . . From the buyer's standpoint, the $300, if treated as part of the price of the property would be added to the basis of the property and, in the case of depreciable property be recoverable over the life of the property. He might also, if the property qualified, be eligible for an investment credit with respect to this $300. On the other hand, if this $300

F. *Inequality: The Basis Computation*

Where market value equivalency exists, the sham doctrine is

> were treated as interest, he could receive an interest deduction for this amount.
> (b) *General reasons for provision.*— Your committee agrees with the House that there is no reason for not reporting amounts as interest income merely because the seller and purchaser did not specifically provide for interest payments.

S. REP. No. 830, 88th Cong., 2d Sess. 101, *reprinted in* (1964) U.S. CODE CONG. & AD. NEWS 1673, 1774.

It must be emphasized that this explanation of the status of the law, as in existence prior to the enactment of § 483, is entitled to little weight, for it is nothing more than an appraisal by a subsequent Congress of an intent that was entertained by an earlier one. *See* Theodore H. Davies & Co. v. Commissioner, 75 T.C. 443 (1980); United Telecommunications, Inc., v. Commissioner, 65 T.C. 278, 287 (1975), *aff'd,* 589 F.2d 1383 (10th Cir. 1978). In fact, as indicated in text, the proper treatment of discount had never been resolved by the Supreme Court.

The Committee on Ways and Means explained its view of the impact of § 483 upon a taxpayer who purchases property by issuing a note or obligation:

> Section 483(a) provides the general rule that part of each payment (under a contract for the sale or exchange of property) to which section 483 applies is to be treated as interest for all purposes of the code. The tax treatment of both the purchaser and the seller may be affected by the rules of Section 483. Thus, the basis of property in the hands of a purchaser does not include that part of his payments under the contract which is treated as interest under Section 483 and he is entitled to interest deductions for such part in accordance with his method of accounting.

H. REP. No. 749, 88th Cong., 1st Sess. A84, *reprinted in* (1963) U.S. CODE CONG. & AD. NEWS 1313, 1510. Thus, one might conclude that any debt-financed purchase that is subject to the provision of § 483 will result in a basis equal to the face amount of the debt, regardless of the value of the asset acquired, unless § 483 requires a recharacterization of a portion of the face amount as interest. If such a recharacterization is required, the basis of the property would be equal to the face amount of the debt less the amount of interest so recharacterized.

This, however, may be too broad a view of the section. The section is not applicable where a sufficient rate of interest is agreeed to by the purchaser and seller. *See* Treas. Reg. § 1.483-1 (1981). In such a situation, the computation of the purchaser's basis would seem to be unaffected by § 483 principles. This conclusion seems appropriate in light of the fact that § 483 was enacted in order to prevent purchasers and sellers from selecting too low a rate of interest. When, however, a sufficient rate of interest is selected by the purchaser and seller, it is arguable that § 483 should not preclude the contention that even more interest is inherent in the transaction in the form of discount. In sum, it is suggested that § 483 may have the effect of creating a floor — a minimum rate of interest must be selected by the purchaser and seller or the section will impute it — but not a ceiling — the parties may be free to argue that discount is present such that the true amount of interest exceeds the rate explicitly selected.

Perhaps, this approach to § 483 is even applicable where the parties provide for no interest. In such circumstances, § 483 principles will impute a minimum amount of interest. Imputing a minimum amount of interest, however, should not preclude the argument that even more interest is present in the form of discount.

The computation of basis, in this context, is not conclusively resolved by § 483. Nonethe-

inapposite. Inequality, on the other hand, does not always require application of the doctrine. As previously suggested, a taxpayer might agree to pay more for an asset than its fair market value by virtue of: 1) a mistake; 2) a desire to obtain some additional benefit or asset from the seller; or 3) a desire to obtain tax reduction. The sham doctrine is only operative where tax reduction is the sole motive for the overpayment.

1. *Mistake*

While there is a paucity of authority on the question of mistaken overpayment, those courts that have addressed the question have concluded that the taxpayer should not be penalized for such inadventure.[93]

In *Hedges v. Commissioner*,[94] the taxpayer was a member of a partnership engaged in drilling and developing oil and gas wells. The partnership entered into an agreement with a drilling contractor, pursuant to which the drilling contractor agreed to drill wells for the partnership for a fixed sum. The drilling contractor then arranged to have a subcontractor drill the wells for the partnership at a price below the fixed sum paid by the partnership.[95] The tax-

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less, one might well argue, referring to the Senate Finance Committee report on § 483, that discount should not be recognized — basis should always equal purchase price irrespective of the asset's fair market value — unless § 483 applies, in which case interest should be imputed only to the extent provided for in the section. Interestingly, Congress adopted this position by refusing, as a general rule, to acknowledge the discount concept insofar as the seller is concerned where the buyer is a corporation. I.R.C. § 1232(b)(2) and Treas. Reg. § 1.1232-3(b)(2)(iii)(a) (1971).

While it would be administratively convenient to compute, in all cases, imputed interest at the rate provided for under § 483 and thereby preclude taxpayers and the Service from arguing that discount in addition to such imputed interest is present, debt-financed acquisitions that are structured on the basis of discount computed at an interest rate higher than that utilized under § 483 would provide taxpayers, where applicable, with an inflated investment tax credit base. In such circumstances, some portion of the discount would be included in basis. This would be a particularly difficult problem in the context of nonrecourse debt, where the contingent nature of the debt generally results in an interest rate higher than that utilized under § 483, which is designed to apply to all kinds of debt. Perhaps, if different interest rates were applied in imputing interest under § 483 to recourse and nonrecourse debt, administrative convenience would dictate that § 483 principles be the exclusive determinant of the discount question.

93. *See* Commissioner v. Matheson, 82 F.2d 380 (5th Cir. 1936); Spitcaufski v. Commissioner, 13 T.C.M. (CCH) 32 (1954).

94. 41 T.C. 695 (1964).

95. With respect to each well, the fixed sum paid by the partnership to the drilling contractor and the lower amount paid by the drilling contractor to the subcontractor were

payer deducted his share of the partnership's intangible drilling and development costs.[96] The deduction claimed on the partnership return was equal to the fixed sum paid to the drilling contractor by the partnership. The Internal Revenue Service, alluding to the substantially lower sum paid by the drilling contractor to the subcontractor, disallowed that portion of the intangible drilling and development cost that exceeded the amount paid by the drilling contractor to the subcontractor.[97] In essence, the Internal Revenue Service's position was that the partnership had overpaid the drilling contractor and that the amount of overpayment should not be treated as a drilling cost.

The Tax Court, however, concluded that the entire amount paid to the drilling contractor, including that portion characterized by the government as an overpayment, should be treated as a deductible drilling expense.[98] Apparently, the court was reluctant to disregard the price agreed upon, though foolishly, by the taxpayer. Subsequent to its decision in *Hedges*, the Tax Court, in *Bernuth v. Commissioner*,[99] discussed this reluctance:

> Where a taxpayer enters into a contract for the drilling of a well, and through inexperience or otherwise, agrees to pay too much when compared to the "going rate" for the drilling of a well in a given field, the amount so agreed upon is not any less the cost to the taxpayer of drilling the well. Under such circumstances, this court will not look behind the agreement of the parties and

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as follows:

<table>
<tr><th></th><th>Fixed sum paid to drilling contractor</th><th>Lower amount paid by drilling contractor to subcontractor</th></tr>
<tr><td>Well #1</td><td>$18,850</td><td>$11,974.50</td></tr>
<tr><td>Well #2</td><td>18,850</td><td>11,466.00</td></tr>
<tr><td>Well #3</td><td>16,000</td><td rowspan="2">24,313.50</td></tr>
<tr><td>Well #4</td><td>16,000</td></tr>
<tr><td>Well #5</td><td>16,000</td><td>12,454.22</td></tr>
</table>

Id. at 697.

96. A taxpayer may elect to either deduct such costs currently or capitalize them. I.R.C. § 263(c) and Treas. Reg. § 1.612-4 (1965).

97. 41 T.C. at 698.

98. While *Hedges* involved the propriety of a deduction in the context of the overpayment of a currently deductible expense, the same analysis should obtain where basis computation is in issue. Indeed, the overpayment in the context of intangible drilling expense in *Hedges* would have been capitalized had the taxpayer so elected. Presumably, such an election would not have altered the court's analysis.

99. 57 T.C. 225 (1971), *aff'd*, 470 F.2d 710 (2d Cir. 1972).

determine the amount allowable as a deduction for drilling costs in terms of the going rate, and the amounts specified in the contract are determinative.[100]

The deference with which the courts treat a price paid by a taxpayer is not, however, without limitation. Where the inflated purchase price results in the taxpayer's acquisition of some other benefit or asset from the seller, or when the overpayment is motivated solely by tax-avoidance objectives, the court will not defer to the taxpayer's price selection. If no additional benefit or asset is acquired from the seller, the taxpayer's state of mind is determinative: If the overpayment is motivated solely by tax-avoidance objectives, the sham doctrine prohibits the inclusion of the overpayment in the basis computation. On the other hand, an overpayment attributable to a genuine mistake is motivated by business objectives — the taxpayer believes, though erroneously, that the price is fair and that he cannot acquire the asset in the marketplace for a lesser amount — and is, therefore, properly included in the computation.[101]

The policy consideration that underlies this treatment of mistake is the protection of a taxpayer who genuinely believes, at the time of acquiring an asset, that the purchase price is equal to the asset's fair market value against second-guessing by the Internal Revenue Service or the courts. This approach also serves the salutary purpose of extricating the courts from the burden of reviewing the prudence exercised by taxpayers in their asset acquisitions. In short, the principle advocated here — that mistaken overpayments should be included in the basis computation — vests the exercise of business judgement in the proper parties, the taxpayers rather than the courts.[102]

Obviously aware of these considerations, the court in *Estate of Franklin v. Commissioner*[103] suggested that where an inquiry into a taxpayer's state of mind discloses that genuine mistake, rather than tax-avoidance objectives, has induced an overpayment, the

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100. *Id.* at 236 (footnote omitted) (citation omitted).

101. Similarly, I.R.C. § 183 should not apply to a mistaken overpayment. *See* Jasionowski v. Commissioner, 66 T.C. 312 (1976), where the court adopted a subjective approach in determining whether economic motivation exists; the expectation of profit need only be "*bona fide.*" *Id.* at 321. *See also* Dreicer v. Commissioner, ___ F.2d ___ (D.C. Cir. 1981).

102. In other contexts as well, courts have refused to review the propriety of a litigant's business judgment. *See, e.g.,* Arsht, *The Business Judgment Rule Revisited,* 8 HOFSTRA L. REV. 93 (1979).

103. 544 F.2d 1045 (9th Cir. 1976).

sham doctrine should not be applied.[104] The *Franklin* court resolved the taxpayer's claimed entitlement to include a nonrecourse debt in basis in favor of the government by implicitly applying the likelihood-of-payment rationale. Utilization of the likelihood-of-payment rationale, resulting in the debt's exclusion from basis, obviated the need for consideration of the sham doctrine.[105] Nevertheless, the court did suggest that while the presence of a genuine mistake has no significance in the context of the likelihood-of-payment rationale, such inadvertence should preclude invocation of the sham doctrine.

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104. *See Estate of Franklin,* where the court said:

> [The taxpayers] spent a substantial amount of time at trial attempting to establish that, whatever the actual market value of the property, Associates [the partnership of which the taxpayers were members] acted in good faith *belief* that the market value of the property approximated the selling price. However, this evidence only goes to the issue of sham and does not supply substance [satisfy the likelihood-of-payment rationale] to this transaction.

544 F.2d at 1048, n.4 (original emphasis). Interestingly, in suggesting that a genuine mistake might preclude application of the sham doctrine, the court assumed that the determination of whether or not such a mistake is present would be made at the partnership level. What result would be appropriate if, while all of the limited partners have an inflated view of fair market value, the general partner has an accurate view but fails to disabuse the limited partners? Perhaps the knowledge of the general partner should be imputed to the partnership (*see* UNIFORM PARTNERSHIP ACT § 12) and the limited partners should be relegated to the appropriate action against the general partner under the federal securities or state laws.

If, on the other hand, the partnership is viewed as an aggregate of its members (*see, e.g.,* McKee, *Partnership Allocations: The Need for an Entity Approach,* 66 VA. L. REV. 1039 (1980)), one might argue that a fragmented basis should result — that portion of the partnership's basis in the acquired asset attributable to the general partner would be computed by reference to the asset's fair market value, while the portion of such basis attributable to the limited partners would be computed by reference to the inflated purchase price. Similarly, each partner would be deemed to have contributed an amount of cash to the partnership (for purposes of computing the basis of each partner in his partnership interest), pursuant to I.R.C. § 752(a), equal to his share of the fragmented partnership liability incurred in acquiring the asset — the portion of the liability attributable to the general partner would not take into account the overpayment, while the entire amount of the liability attributable to the limited partners would be taken into account. It must be conceded, however, that the concept of fragmenting basis and liability is novel. *See* Honodel v. Commissioner, 76 T.C. 351 (1981). *Cf.* I.R.C. § 754, which creates a fragmented basis concept in another context. *See also,* Goldfein & Weiss, *An Analysis of the Proposed Changes Under Circular 230 Affecting Tax Shelter Opinions,* 53 J. TAX. 340, 346 (1980), where it is suggested that, at least in the context of the fraud and negligence penalties (I.R.C. § 6653), the wrongful conduct of the general partners should not be imputed to the limited partners. For a contrary result, in the general partnership context, *see* Calvey v. United States, 448 F.2d 177 (6th Cir. 1971).

105. In some situations, analysis of the sham doctrine may be necessary even though the likelihood-of-payment rationale precludes inclusion of the nonrecourse note in basis. *See* text accompanying notes 149-59 *infra.*

This distinction between the sham doctrine and the likelihood-of-payment rationale is a sensible one. Assume, for example, that a taxpayer purchases an asset with a fair market value of $100 by delivering a nonrecourse note to the seller in the amount of $200. In these circumstances, the likelihood-of-payment rationale requires the conclusion that the nonrecourse note does not have sufficient substance to be included in the basis computation, since it would be improbable for a taxpayer to discharge a $200 obligation in order to retain an asset with a value of $100. Under this analysis the taxpayer's basis would be zero, and there would be no need to examine the sham doctrine. What result should obtain if the taxpayer were to establish that at the time of acquiring the asset, he honestly believed that the asset's fair market value was $200? The conclusion that basis is zero should not be affected by the taxpayer's mistake since the taxpayer's state of mind, at the time of acquisition, does not increase the likelihood of payment. To be sure, when the taxpayer learns of his mistake, at a point in time after the acquisition documents are executed, he will, with impunity, simply refuse to make payments on the note.[106]

This result is to be contrasted with the role of a mistaken overpayment in the context of the sham doctrine. Assume, for example, a taxpayer purchases an asset with a fair market value of $100 by delivering $100 in cash and a $100 nonrecourse note, with a value of $100, to the seller. Since the amount of the note is equal to the asset's fair market value, there is sufficient inducement for the taxpayer to discharge the note such that the likelihood-of-payment rationale does not preclude the inclusion of the note in basis. The sham doctrine, however, is potentially applicable here. If the taxpayer agrees to pay $200 ($100 in cash and $100 in note) for an asset with a value of $100 solely in order to accomplish tax avoidance, the sham doctrine will require disregard of that portion of the purchase price that exceeds the asset's fair market value, thus limiting the taxpayer's basis to $100, the fair market value of the

106. If, on the other hand, the taxpayer does not learn of his mistake prior to making payments with respect to the note, such payments should be included in basis. Where a nonrecourse note is not included in the basis computation by virtue of the likelihood-of-payment rationale and payments are subsequently made in discharge of the note, such payments are added to basis. *See* Associated Patentees, Inc. v. Commisssioner, 4 T.C. 979 (1945). In addition, the sham doctrine should not apply to such payments, for, as suggested, payments made by virtue of a mistaken assumption as to market value are motivated by economic objectives rather than a desire to avoid tax obligations.

asset.

If, on the other hand, the taxpayer genuinely believes the fair market value of the asset to be $200, his basis should equal $200. In these circumstances, the taxpayer is motivated by business objectives to deliver the $100 in cash to the seller — it is the taxpayer's perception that seller will not sell if he does not make this cash payment. The taxpayer will also be motivated by business objectives to make payments on the note, for a failure to make such payments will result in forfeiture of the asset. Since the taxpayer is motivated by business objectives to deliver the cash and note, and since, even if the taxpayer learns of his mistake as to value after executing the acquisition documents, the taxpayer will be motivated to continue to make payments on the note by virtue of his desire to retain the asset (certainly a business objective), the sham doctrine should not apply.

The observation of the *Franklin* court that the taxpayer's mistake concerning value is not pertinent to the likelihood-of-payment rationale is cogent.[107] The court's implicit observation that a mis-

107. It should be noted that, in the concluding paragraph of its decision, the court indicated that "[b]ad bargains from the buyer's point of view . . . do not thereby cease to be sales." Although the language should be viewed as having significance in the sham context only, the court, in Hager v. Commissioner, 76 T.C. 759 (1981), has construed it as a statement that a buyer's bad bargain may affect the likelihood-of-payment analysis.

Moreover, while mistaken assumptions as to value should have no significance in the context of the likelihood-of-payment analysis, such mistakes are relevant in connection with the penalty provided for in I.R.C. § 6659 (effective with respect to tax returns required to be filed after December 31, 1981), added by The Economic Recovery Tax Act of 1981, § 722(a)(1). This section, which imposes a penalty on underpayments that result from an overstated basis or an overstated valuation, empowers the Secretary of the Treasury to waive its application if the excessive basis or valuation is supported by a reasonable basis and is claimed by the taxpayer in good faith. For example, assume a taxpayer purchases an asset with a value of $100,000 by delivering to the seller a nonrecourse note in the amount of $300,000 on the mistaken assumption that the asset has a value of $300,000. The taxpayer's basis in the acquired asset should be zero, since the note, having an insufficient likelihood of payment, should not be included in basis. If the taxpayer were, nevertheless, to claim on his tax return a basis of $300,000, he would be potentially subject to the § 6659 penalty with respect to the underpayment resulting from a reduction of basis to zero. The Secretary of the Treasury, however, is permitted to waive this penalty, if he concludes that there was a reasonable basis for the taxpayer's impression of value and that the taxpayer made the mistake in good faith.

Thus, while the taxpayer's mistake is not a predicate for relief insofar as his basis computation is concerned, it may enable the taxpayer to avert the § 6659 penalty. This distinction between basis computation and penalty is sound. Although it is inappropriate to allow a taxpayer to include in basis a nonrecourse note that, in all likelihood, he will not pay, it seems rather harsh to subject a taxpayer to a penalty for delivering such a note when its

taken overpayment should not activate the sham doctrine[108] is equally persuasive.

2. *Multi-Asset/Multi-Benefit Transactions*

Where a buyer agrees to pay more than fair market value for an asset and the overpayment is attributable to the buyer's mistake, the buyer's basis is equal to the purchase price selected by the parties.[109] In the absence of mistake, however, such inequality will always precipitate a basis for the asset acquired that is less than the purchase price. This effect results from either the operation of the sham doctrine or the doctrine that gives tax effect to the realities of a transaction rather than the form selected by the taxpayer.

Students of taxation are familiar with the principle that transactions are treated, for tax purposes, in accordance with their sub-

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delivery is the product of a good-faith mistake.

108. It must be conceded that some administrative convenience is inherent in this approach. The courts will be required to examine the taxpayer's state of mind in making the mistake analysis. In addition, taxpayers will probably be encouraged to play the "audit lottery" by taking the position on their tax return that all payments made in connection with the acquisition of property should be included in basis without regard to the property's fair market value. The rationale for such a position would presumably be that if an overpayment is present, it is attributable to mistake. However, the alternative, penalizing the taxpayer for his mistake, is certainly not preferable.

Parenthetically, it should be noted that the reluctance of the courts to examine a taxpayer's business acumen or exercise of business judgment is not limited to transactions involving the principles of basis computation inherent in the sham doctrine. Indeed, the Internal Revenue Service itself has issued regulations in the gift tax context which protect sellers who make mistakes as to valuation from adverse transfer tax consequences. Treas. Reg. § 25.2512-8 (1958). Such sales receive the protection of the regulations provided the sale is made in the "ordinary course of business." *Id.* While, therefore, a taxpayer who sells an asset for less than its fair market value by virtue of a mistake is entitled to impunity under the regulations, a taxpayer who makes such a sale with full knowledge of the facts is subject to the gift tax. In essence, the protection from the gift tax conferred upon sellers who mistakenly agree to sell for less than fair market value is the counterpart to the principle that the sham doctrine does not prevent a buyer from including in his basis that portion of the purchase price attributable to mistakes.

109. This conclusion should be altered, however, where a discount is present. *See* text accompanying notes 81-92 *supra*. For example, if a taxpayer agrees to purchase an asset with a value of $100 for $100 in cash and a nonrecourse note with a face amount of $75 and a value of $50, under the mistaken impression that the asset has a value of $150, the taxpayer's basis should equal $150; in addition, of course, an interest deduction in the amount of $25 should be available in the appropriate taxable years. In this example, while the purchase price selected by the parties is $175 (consisting of $100 in cash and $75 in note), basis should only be $150, the amount the taxpayer mistakenly believes is the true value of the asset.

stance rather than the form in which they are cast by the taxpayer.[110] This tenet has been applied, in the context of an acquisition of a group of assets, in order to determine whether the amounts designated as the purchase price with respect to any particular asset in the acquisition documents represents, as a matter of economic reality, the true cost of that asset.[111] Basis will equal the purchase price allocated in the acquisition documents only when such economic reality is present. Conversely, where the purchase price is incompatible with economic reality, courts will determine basis in accordance with their perception of the asset's true economic cost. In effect, when confronted with a multi-asset transaction, courts will not allow a taxpayer to allocate basis to any individual asset that is in excess of the asset's fair market value.[112]

Where a taxpayer acquires an asset for a purchase price that exceeds the asset's fair market value, inquiry is necessary in order to determine whether a multi-asset acquisition or other type of multi-benefit transaction is present. If it is determined that the taxpayer has acquired, in the same transaction, some other additional asset or benefit, the portion of the purchase price in excess of the asset's fair market value should be attributed to the other asset or benefit acquired in the transaction.

In *New Hampshire Fire Insurance Co. v. Commissioner*,[113] the taxpayer, an insurance company, sold its own stock in 1929 to some of its agents at $60 per share. In 1936 the market value of the taxpayer's stock was approximately $42 per share. Because of its desire to maintain an appropriate attitude among its agents,[114] the taxpayer, in 1936, reacquired its stock from its agents for $57.75 per share.[115] Shortly thereafter, the taxpayer sold the reacquired stock for approximately $42 or $43 per share, claiming a loss for

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110. *See, e.g.*, Helvering v. Clifford, 309 U.S. 331 (1940); Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

111. *See, e.g.*, F. & D. Rentals, Inc. v. Commissioner, 44 T.C. 335 (1965), where a taxpayer purchased inventory and fixed assets. The acquisition documents allocated the purchase price between the inventory and the fixed assets. The Internal Revenue Service contended that the allocation contained in the acquisition documents was unrealistic—it sought to increase the allocation with respect to fixed assets and decrease the allocation with respect to inventory in the same amount. *See also* Rev. Rul. 79-432, 1979-2 C.B. 289.

112. *See* note 111 *supra*.

113. 2 T.C. 708 (1943).

114. *Id.* at 718.

115. The market value, at the time of reaquisition, "was about $42 or $43 per share." *Id.*

the difference between the sales price and the price it paid its agents of $57.75 per share.[116] The Internal Revenue Service disallowed the loss on the rationale that the taxpayer's basis with respect to the reacquired stock should not exceed the fair market value of the stock on the date of reacquisition, $42 or $43 per share.[117] The Tax Court sustained the disallowance, reasoning that the scope of the 1936 transaction between the taxpayer and its agents extended beyond the reacquisition of stock.[118] The taxpayer was motivated, the court found, to pay more than fair market value for the stock in order to "keep faith" with its agents.[119]

The taxpayer's basis with respect to the reacquired stock was limited to its fair market value on the date of reacquisition.[120] Presumably, the difference between the stock's purchase price and its fair market value on the date of reacquisition, being attributable to the taxpayer's desire to "keep faith" with its agents, would be deductible, in the year of reacquisition, as a business expense.[121] In any event, the court's finding that the overpayment, with respect to the stock acquisition, was motivated by the taxpayer's desire to maintain a strong relationship with its agents precluded the inclusion of the overpayment in the stock's basis.

In *Majestic Securities Corporation v. Commissioner*,[122] the corporate taxpayer purchased securities from another corporation. Both the taxpayer and the corporation from which the securities were acquired were owned substantially by the same shareholders, though not in the same proportion. The purchase price for the securities acquired was in excess of the price at which these securi-

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116. I.R.C. § 1032, enacted in 1954, provides that a corporation does not recognize gain or loss upon the sale of its own stock. Prior to 1954, however, it had been held that the sale of treasury stock did result in gain or loss. *See* BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 3-51 (1979).

117. 2 T.C. at 723-25.

118. *Id.*

119. *Id.*

120. "Prices in excess of market paid for personal reasons are not the correct measure of cost." *Id.* at 724 (citations omitted).

121. Inasmuch as the court disallowed the loss claimed by the taxpayer without discussion of a possible business expense deduction, one might assume that the court was of the view that no such deduction was appropriate. However, it is also possible that the court concluded, albeit not explicitly, that such a deduction was unavailable by reason of public policy concerns — generally, insurance companies are severely circumscribed, under state law, from compensating their agents in excess of certain scheduled commission rates. For a subsequent codification of this public policy theory, *see* I.R.C. § 162(c).

122. 42 B.T.A. 698 (1940), *aff'd*, 120 F.2d 12 (8th Cir. 1941).

ties were trading on a stock exchange. When computing its gains and losses upon the subsequent sale of these securities, the taxpayer claimed a basis equal to purchase price. The government, however, contended that the taxpayer's basis should be limited to the fair market value of the securities on the date of purchase.

Agreeing with the government, the Board of Tax Appeals held that the taxpayer failed to prove that "the amount paid was for no purpose other than the acquisition of the securities."[123] Before reaching this conclusion, the court surmised that the purpose of the overpayment was to provide funds to the corporation from which the securities were acquired in order to maintain its solvency.[124] The court derived this inference from the fact that the taxpayer and the seller of the securities were substantially owned by the same parties.

In essence, the taxpayer accomplished two objectives when it executed the purchase from the other corporation: 1) it obtained the securities, and 2) it helped maintain the solvency of the seller. The latter accomplishment, however, inured solely to the benefit of the taxpayer's shareholders. Although the court did not address this issue, it appears that the overpayment constituted a dividend to the taxpayer's shareholders.[125] To be sure, however, the taxpayer, having secured some benefit in addition to the securities in the transaction, was properly prevented from including the overpayment in basis.

Thus, a taxpayer who pays more than fair market value for an asset in order to secure some additional asset or benefit should not be permitted to reflect the entire purchase price in basis. Rather, the taxpayer should be required to compute basis in accordance with the economic realities of the transaction: The portion of the purchase price attributable to the asset acquired constitutes basis, and the balance of the purchase price, being attributable to the acquisition of the additional asset or benefit, is characterized by reference to the nature of the additional asset or benefit acquired.

3. *Tax-Motivated Overpayments: Sham*

In contrast to a mistaken overpayment or an overpayment mo-

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123. *Id.* at 702.
124. *Id.* at 701.
125. *See* BITTKER & EUSTICE, *supra* note 116, at 7-27.

tivated by a desire to obtain some additional asset or benefit — both of which are motivated by economic objectives — an overpayment that is motivated solely by tax avoidance objectives is violative of the sham doctrine. The courts have, on several occasions, held that an overpayment motivated solely by a desire to inflate basis or otherwise effect tax reduction is not to be given effect. The Internal Revenue Service, as well, has begun to issue rulings that implicitly address the relationship of the sham doctrine to such overpayments.[126]

These rulings and decisions are supported by sound policy objectives. It would make little sense to allow a taxpayer who acquires an asset to include in his basis computation any amount in excess of the asset's fair market value when the taxpayer, being fully aware of the asset's value, requests that the seller inflate the purchase price in order to accommodate the taxpayer's tax-avoidance objectives. If transactions such as these were given respect for tax purposes, the government would, in effect, be offering to reduce the tax bill of all taxpayers sufficiently sophisticated to create the necessary artifice, at the expense of the remaining, less sophisticated taxpayers. While the law does intentionally confer, in various contexts, advantages upon wealthy and sophisticated taxpayers that are not available to the remainder of the taxpaying population, such provisions generally are designed to encourage behavior that is beneficial to society.[127] Obviously, Congress has decided that the inequity inherent in such provisions must be suffered in order to secure a more important goal. However, with respect to the purchaser who intentionally pays more than market value for an asset solely in order to inflate his basis, society is not at all enriched and, thus, equity should be preserved by denying the taxpayer the personal enrichment he seeks from an overstated basis. Moreover, the important objective of securing compliance in our self-assessment system of taxation is adversely affected when the public perceives that special advantages are uniquely available to

126. *See* Rev. Rul. 79-432, 1979-2 C.B. 289; Rev. Rul. 80-42, 1980-1 C.B. 182.

127. For example, while I.R.C. § 170 renders $70 in tax reduction to a 70% taxpayer for $100 of charitable contribution, it only produces $20 in tax reduction for a 20% taxpayer with respect to the same amount of charitable contribution. This inequity is tolerated on the rationale that it encourages charitable contributions. *See* Bittker, *Charitable Contributions: Tax or Matching Grants*, 28 TAX L. REV. 37 (1972); Levi, *Financing Education and the Effect of the Tax Laws*, XXXIX LAW AND CONTEMPORARY PROBLEMS 75 (1975).

the wealthy and the sophisticated.[128]

The Tax Court, in *Mountain Wholesale Co. v. Commissioner,*[129] obviously concerned about these policy objectives, invoked the sham doctrine in the basis computation context. There, a corporation which was encountering financial difficulties sold its receivables to the corporate taxpayer. Substantially all of the taxpayer's stock was initially owned by the seller corporation. Upon liquidation, the seller corporation distributed its stock in the taxpayer to its shareholders — in effect, the shareholders of the seller became, as a result of the liquidation, the taxpayer's shareholders. The price agreed upon by the taxpayer and the seller for the receivables was equal to their face amount. The taxpayer paid the purchase price by assuming a debt of the seller corporation. Upon failing to collect the face amount of these receivables, the taxpayer claimed a bad debt deduction. The government, however, argued that the taxpayer's basis in the receivables was limited to their fair market value at the time of acquisition and therefore the court should sustain the disallowance of the deduction to the extent that the face amount exceeded the fair market value of the receivables.[130]

The court, noting that the receivables were from one to eight years old at the time of the taxpayer's acquisition, agreed with the government's contention that their fair market value was substantially less than their face amount. Since the financial difficulties of the seller corporation and its concomitant lack of income precluded it from enjoying the tax benefit inherent in a bad debt deduction, the court inferred that the only explanation for the taxpayer's willingness to overpay was the desire to secure the bad debt deduction for itself — a deduction that would obviously inure to the ultimate benefit of the taxpayer's shareholders, who were also substantial owners of the seller corporation, and which would otherwise be forfeited. Having determined that the overpayment

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128. Fabreka Products Co. v. Commissioner, 34 T.C. 290, 301-02 (1960) (concurring, Pierce, J.). *See, e.g.*, Blum, *Tax Policy and Preferential Provisions in the Income Tax Base, in* HOUSE COMM. ON WAYS AND MEANS, 1 TAX REVISION COMPENDIUM 77, 82 (1959); Roberts, Friedman, Ginsburg, Louthan, Lubick, Young & Zeittlin, *A Report on Complexity and the Income Tax,* 27 TAX L. REV. 325 (1972); Coven, *The Alternative Minimum Tax: Proving Again That Two Wrongs Do Not Make a Right,* 68 CAL. L. REV. 1093 (1980).

129. 17 T.C. 870 (1951).

130. I.R.C. § 166 provides that a bad debt may be deducted to the extent of the taxpayer's basis in the debt.

was motivated solely by tax avoidance objectives, the court invoked the sham doctrine and consequently sustained the government's disallowance.[131] The court disregarded the taxpayer's overpayment and held that its basis in the receivables was equal to their fair market value at the time of acquisition.

The Tax Court again had occasion to invoke the sham doctrine in the basis computation context in *Bixby v. Commis-*

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131. The taxpayer also purchased a warehouse from the other corporation at a purchase price which, the court found, was in excess of fair market value. In limiting the taxpayer's basis with respect to the warehouse to fair market value, the court did not explicitly rest its holding, as it did with respect to the receivables, on the sham doctrine. Indeed, in one portion of its opinion, 17 T.C. at 874-75, the court implied that it was of the view that the overpayment was motivated by the taxpayer's desire to obtain some additional asset or benefit. Perhaps, the court did not think it necessary to decide whether this motivation or the desire to avoid tax was responsible for the overpayment on the warehouse, inasmuch as, in either case, the taxpayer's basis for the warehouse would be equal to its fair market value.

Although the court did explicitly invoke the sham doctrine with respect to the receivables, one might argue that the court's basis computation for the receivables was also supportable on the theory that the overpayment was motivated by the taxpayer's desire to provide financial aid to the seller corporation—aid that inured to the benefit of the taxpayer's shareholders. *See* text accompanying notes 123-25 *supra*. The blending of these two concepts—overpayment motivated by tax avoidance objectives and overpayment motivated by a desire to obtain some additional asset or benefit—is also illustrated in Investors Diversified Services, Inc. v. Commissioner, 39 T.C. 294 (1962), *aff'd*, 325 F.2d 341 (8th Cir. 1963). There, the taxpayer supplied mortgage funds to purchasers of homes that were built by a corporation that was wholly owned by the taxpayer. The fair market value of the mortgage note received by the taxpayer was less than the amount of the funds supplied by the taxpayer to the purchaser. It was the custom in the industry, with respect to the kinds of mortgages involved, for the builder of the home to compensate the lender for the difference between the fair market value of the mortgage note and the amount of funds supplied to the purchaser. The taxpayer, however, owning all of the stock in the corporate builder, decided to waive this compensation. When the taxpayer sold these mortgages, he claimed, as a basis, the amount of funds it supplied to the purchasers. The government, on the other hand, argued that the taxpayer's basis in the mortgages should be limited to their fair market value at the time of their acquisition.

In agreeing with the government, the court noted that tax-avoidance considerations played a role in the taxpayer's decision to forego compensation from the builder. *Id.* at 307. However, the court resolved the issue on the basis of its conclusion that the overpayment with respect to the mortgage was, in effect, a capital contribution by the taxpayer to the builder. *Id.* at 308. Thus, the court's analysis appears to focus on the taxpayer's desire, in making the overpayment, to acquire a benefit in addition to the mortgages—the benefit inherent in making a capital contribution to a wholly owned subsidiary. An important byproduct of this analysis is that the taxpayer would presumably be permitted to increase its basis in its stock in the subsidiary by virtue of the court's finding of a capital contribution, whereas a finding of sham would probably dictate a less favorable result for the taxpayer.

Thus, the distinction between these two different types of overpayments is not always a clear one.

sioner.[132] A corporate taxpayer was contacted about the possibility of purchasing an option to acquire the assets of another corporation. The taxpayer, interested in making the acquisition, caused certain related trusts[133] to purchase the option. While the cost incurred by the trusts in acquiring the option was only $63,500, the trusts immediately resold the option to the taxpayer for $1,641,526.75. Instead of paying cash for the option, the taxpayer gave the trusts ten year subordinated debentures, which were recourse in nature, in the face amount of $1,641,526.75. The taxpayer, after exercising the option, claimed depreciation deductions which were computed by reference to a basis that included the face amount of the debentures. The government's argument, in essence, was that the taxpayer should not be permitted to include the option price in the basis of the assets acquired to the extent that the price of the option ($1,641,526.75) exceeded its fair market value.[134]

Sustaining the government's position, the court invoked the sham doctrine. In so doing, the court agreed with the government's argument that the fair market value of the option was $63,500, the price paid for the option by the trusts. The court was also of the view that the overpayment was motivated solely by a desire to accomplish tax reduction.[135] These findings properly led the court to its conclusion that the sham doctrine was applicable.[136] Accord-

132. 58 T.C. 757 (1972).

133. The beneficiaries of these trusts were substantially the same parties as the beneficiaries of a trust which owned all of the taxpayer's stock. *Id.* at 759.

134. The government argued that the price of $63,500 paid by the trusts for the option represented its fair market value. *Id.* at 774.

135. The court stated its findings as to the motivation for the overpayment: "[W]e are convinced that the only reasons [the taxpayer] issued the notes were 1) to get the stepped-up basis, 2) to obtain the interest deduction, and 3) perhaps to prepare for a future 'pay out' of profits." *Id.* at 783-84. The first reason proferred by the court supports the sham conclusion. However, the third reason is troublesome. Is the court suggesting, in its statement of the third reason, that business objectives motivated the overpayment? If it is, its decision to invoke the sham doctrine is difficult to rationalize. Perhaps the proper view of the third reason is that it, too, represents a tax-avoidance objective—the taxpayer's desire to pass its earnings to its shareholders on a tax-deductible basis. This perspective of the third statement is confirmed by the court's reliance on the doctrine developed by the Second Circuit in Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), to the effect that interest deductions are unavailable when the transaction that results in the interest obligation is motivated solely by tax-avoidance objectives.

136. The court suggested that it was the taxpayer's decision to interpose the trusts between the corporation offering the option and itself, rather than the overpayment, that activated the sham doctrine. 58 T.C. at 777. In other portions of its opinion, however, the court

ingly, the taxpayer's basis for the option was held to equal $63,500, its fair market value, and, of course, the taxpayer was permitted to include this amount in its basis for the assets acquired upon exercise of the option.

The Tax Court also relied upon a finding of tax-avoidance motivation in order to prevent a taxpayer from inflating basis in *Morris v. Commissioner*,[137] a somewhat more difficult case. There, the corporate taxpayer purchased a motel by taking subject to first mortgage notes with an unpaid balance of $333,800 and second mortgage notes with an unpaid balance of $173,962.67 (both the first and second mortgage notes were nonrecourse in nature). The taxpayer's stock was owned by two shareholders, a husband and wife. The husband, as a part of the same transaction in which the taxpayer purchased the motel, acquired the second mortgage notes from their holder. The taxpayer computed its depreciation deduction by reference to a basis that included the amounts outstanding on both the first and second mortgage notes.

The Tax Court determined that the fair market value of the motel, at the time of acquisition, was $333,800.[138] It then, in essence, concluded that since the fair market value of the motel was equal to the unpaid balance on the first mortgage notes, the second mortgage notes represented an overpayment.[139] In holding that this overpayment was improperly included in the basis computation, the court noted that the second mortgage notes, which were held by the party who owned and controlled the taxpayer,[140] were "solely a device to inflate the true cost of the property for tax purposes."[141] While this finding that the overpayment was motivated solely by tax-avoidance objectives is suggestive of sham, an explicit reference to the doctrine is conspicuously absent from the court's

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alluded to those authorities that have invoked the sham doctrine in disregarding overpayments motivated solely by tax-avoidance objectives. *Id.* at 776. Perhaps, disregard of the interposition of the trusts, by reason of a complete lack of a business motivation for their presence, is but another way of stating that the tax avoidance objectives that motivated the overpayment engaged the sham doctrine.

137. 59 T.C. 21 (1972).

138. *Id.* at 31.

139. *Id.* at 33.

140. Although in one portion of its opinion the court indicated that the holder of the debt was the party who owned and controlled the taxpayer (*id.* at 34) it should be noted that the taxpayer was owned by a husband, who had acquired the second mortgage notes, and his wife. *Id.* at 29.

141. 59 T.C. at 34.

decision. Moreover, immediately following this finding, the court cited *Crane* and, therefore, invoked the likelihood-of-payment rationale to support its holding that the liability on the second mortgage notes was not includible in the basis computation.

Did the court intend to invoke the likelihood-of-payment rationale or the sham doctrine? Inasmuch as the court permitted the taxpayer to include the liability on the first mortgage notes in its basis computation, it is improbable that the court's decision rested on the likelihood-of-payment rationale; for when this rationale is applied, the basis computation does not include any portion of the nonrecourse liability.[142] Indeed, had the court applied the likelihood-of-payment rationale, it should have excluded the first mortgage notes as well as the second mortgage notes from basis: only an imprudent taxpayer would have discharged any portion of either of these notes (having an aggregate face amount substantially in excess of the value of the motel), since failure to fully discharge both of these notes would inevitably result in a forfeiture of the motel. Since the sham doctrine, on the other hand, only excludes from the basis computation that portion of the liability that exceeds the asset's fair market value,[143] the court's holding is compatible with this mode of analysis.

While the court appeared to contemplate the sham doctrine, it would seem that the doctrine should not have been applied to the mortgage notes.[144] Inequality of consideration, an essential predicate for application of the doctrine, was not present. Indeed, the court found that the amount of the first mortgage notes was equal to the value of the motel and that, consequently, the second mortgage notes were worthless.[145] In effect, therefore, the value of the consideration package delivered by the taxpayer to the seller — the value of the first mortgage notes only, since the second mort-

142. *See* text & accompanying notes 14-29 *supra*.

143. There are, however, situations where application of the sham doctrine should result in a basis less than fair market value. *See* text accompanying notes 149-71 *infra*. Indeed, it is arguable that *Morris* presents such a situation. *See* text accompanying notes 158-60 *infra*.

144. This is not to suggest that the mortgage notes should have been included in basis. *See* note 158 *infra*. Moreover, while the mortgage notes in themselves should not be viewed as a sham, the transaction, examined in its entirety, may nevertheless be viewed as a total sham, which will be suggested (*see* text & accompanying notes 158-60 *infra*), or a partial sham (*see* text & accompanying notes 156-57 *infra*).

145. Since the amount of the first mortgage notes was equal to the value of the motel, the second mortgage notes had, at most, nuisance value. 59 T.C. at 31.

gage notes were worthless — was approximately equal to the value of the motel, the consideration package received by the taxpayer.[146]

Given this perspective on inequality and the sham doctrine, the doctrine will play a limited role with respect to a transaction involving nonrecourse debt in excess of the fair market value of the asset acquired. For example, if a taxpayer were to purchase an asset with a fair market value of $100 by delivering a $200 nonrecourse note to the seller, the equality of consideration should preclude operation of the sham doctrine: the value of the asset received by the taxpayer is $100; the value of the nonrecourse note delivered by the taxpayer to the seller is also $100, by virtue of the fact that, in the event of a foreclosure, the holder of the nonrecourse note could not realize more than the fair market value of the asset securing the note, $100. In short, in the context of this hypothetical, the value of the note can never exceed the value of the asset securing it, and the resulting equality of consideration makes the sham doctrine inapplicable. This is not to suggest, however, that basis should equal $200. On the contrary, in accordance with the likelihood-of-payment rationale, basis should be zero.[147] Thus, there is no need to apply the sham doctrine in this context.[148]

In some circumstances, however, the sham doctrine will have application with respect to a transaction in which the nonrecourse note has a face amount in excess of the value of the acquired asset. For example, assume a taxpayer purchases an asset with a value of $100 by delivering $50 in cash and a $200 nonrecourse note to the

146. The taxpayer also provided the seller with $25,000 in cash. *Id.* at 32. Thus, if there was any inequality, it was only present to the extent of $25,000—the difference between 1) the sum of the value of the first mortgage notes (which was also the value of the motel) and the $25,000 in cash and 2) the value of the motel. For a discussion of the appropriate treatment of the $25,000 cash payment, *see* text accompanying notes 158-60 *infra*.

147. *See* text & accompanying notes 14-36 *supra*.

148. *But see* Gallagher, *Fiscal Alchemy and the Crane Rule: Alternative Solutions to the Tax Shelter*, 8 CONN. L. REV. 607, 629 (1976), where it is suggested that the "purposeless activity" doctrine of *Goldstein* and presumably the sham doctrine are applicable in this context, but difficult to apply. Moreover, it is perhaps arguable that where a nonrecourse note is intentionally structured to substantially exceed the fair market value of the encumbered asset for the sole purpose of accomplishing tax reduction, the sham doctrine should apply despite the equality of consideration. As indicated in text, however, the question has no practical significance, inasmuch as such a nonrecourse note will always be excluded from basis by virtue of the likelihood-of-payment rationale.

seller. Here, there is an inequality of consideration: the value of the asset is $100: the value of the consideration package delivered by the taxpayer, however, is $150 — the sum of the value of the note, which is equal to the value of the acquired asset, and the cash consideration of $50. If this inequality is not attributable to mistake or the taxpayer's desire to obtain some additional asset or benefit from the seller, the sham doctrine should be applied.

The likelihood-of-payment rationale dictates the exclusion of the $200 nonrecourse note from basis. The sham doctrine, however, must be utilized to determine the appropriate characterization of the $50 cash payment. While it has thus far been suggested that the only purpose of the sham doctrine, with respect to basis computation, is to prevent a taxpayer from claiming a basis in excess of the fair market value of the asset acquired, the doctrine must assume a different function in the context of this hypothetical. This hypothetical presents a transaction that, in its entirety, is a sham. In the hypotheticals previously analyzed under the sham doctrine, the author has opined that only a portion of the transaction should be disregarded as a sham, that is, the portion of the purchase price that is in excess of the fair market value of the acquired asset. Once it is concluded that the entire transaction constitutes a sham, it seems appropriate to disregard, for tax purposes, every aspect of the transaction, including the $50 cash payment. Indeed, it would appear that the cash payment, properly characterized, is nothing more than a fee paid by the taxpayer for the services necessary to arrange the sham.

The same policy objectives that enable the tax authorities to disregard the sham transaction itself also compel similar treatment for such fees.[149] Thus, the $50 cash payment, as well as the $200 nonrecourse note, should be disregarded for tax purposes, and the taxpayer's basis should be zero.[150] While this result may seem

149. *See* text accompanying note 128 *supra*.

150. In Knetsch v. United States, 348 F.2d 932 (Ct. Cl. 1965), a taxpayer claimed a deduction for out-of-pocket losses incurred in connection with a transaction which the Supreme Court had previously held was a sham. *See* text accompanying notes 37-50 *supra*. The Court of Claims held that the taxpayer was not entitled to such a deduction, since the transaction was motivated solely by tax-avoidance objectives. The Internal Revenue Service, in Rev. Rul. 77-185, 1977-1 C.B. 48, citing the Court of Claims decision in *Knetsch*, disallowed the transactional costs incurred in a commodity straddle on the rationale that the transaction was completely lacking in economic motivation. I.R.C. § 183 should also have application in this context. *See* note 38 *supra*.

harsh, it must be emphasized that it will only obtain where the entire transaction is a sham. The crucial question, then, is whether a transaction that is potentially a candidate for the sham doctrine constitutes a partial or total sham. A transaction must be deemed a sham in its entirety where, as in the hypothetical under inquiry, a nonrecourse note is to be excluded from the basis computation, by virtue of the likelihood-of-payment rationale.[151] In these circumstances, it would be foolish for the taxpayer to discharge the note, for the only benefit he would thereby secure would be the retention of an asset with a fair market value that is less than the amount payable on the note. In effect, therefore, when a taxpayer makes a cash payment in addition to delivering a nonrecourse note that violates the likelihood-of-payment rationale, in a transaction that purports to be an asset acquisition, he has merely paid a fee for the opportunity to secure tax reduction.[152] Indeed, the transaction yields nothing but tax reduction to the taxpayer, for it is ex-

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In May v. Commissioner, 31 T.C.M. (CCH) 279 (1972), the court, faced with a sham transaction, concluded: "[A]lthough the transaction was dressed up to look like a sale on the basis of which petitioner might claim $365,000 depreciation deductions, all that really occurred here was petitioner's payment of $35,000 for a facade to enable him to claim such deductions." *Id.* at 284. *See also* Dresser v. United States, 55 F.2d 499 (Ct. Cl. 1932), where the court denied a taxpayer a loss deduction incurred in the acquisition of a worthless asset. Since the worthless asset acquired in *Dresser* is analogous to the asset acquired by the issuance of a nonrecourse note which is substantially in excess of the asset's fair market value, the court's analysis is particularly relevant:

> If a taxpayer chooses to pay or contribute money in any transaction, which under all the circumstances known to him at the time, is a hopeless venture, and from which he has no reasonable expectation of profit, he is not entitled to take the amounts paid or contributed as a deduction from income for tax purposes.

Id. at 510. *Accord.* Lewis v. Commissioner, 328 F.2d 634 (7th Cir. 1964); Goodstein v. Commissioner, 30 T.C. 1178 (1959), *aff'd*, 267 F.2d 127 (1st Cir. 1959). These decisions should be contrasted with the First Circuit's decision in *Goodstein;* Lynch v. Commissioner, 273 F.2d 867 (2d Cir. 1957); Fabreka Products Co. v. Commissioner, 34 T.C. 290 (1960); Sherman v. Commissioner, 34 T.C. 303 (1960); Marcus v. Commissioner, 30 T.C.M. (CCH) 1263 (1971).

151. Although this issue was not before it, the court, in *Hager*, 76 T.C. 759 (1981), suggested that "[i]t is possible that whenever a large amount of nonrecourse indebtedness is created in a sale of property and, as a result of the amount of such indebtedness, the buyer fails to acquire an equity in the property, the sale might be entirely disregarded for Federal income tax purposes." *Id.* at 775, n.8. Indeed, in determining that the taxpayer did not have a sufficient profit motive to avoid I.R.C. § 183, the court relied considerably on its finding that the nonrecourse debt unreasonably exceeded the value of the acquired asset. *Id.* at 784.

152. It was proposed, in 1956, that where the nonrecourse debt is in excess of the value of the encumbered asset, basis should equal the amount of the cash payment. The proposal was never enacted. *See* Adams, *supra* note 9, at 165.

pected, at the outset, that the asset will be forfeited.[153] Since no portion of the transaction is motivated by economic objectives, no portion of the transaction, by virtue of the sham doctrine, should be respected for tax purposes:[154] that is, in the absence of some business objective, basis should be zero, notwithstanding the presence of a cash payment.[155]

Contrast this with an asset acquisition in which the taxpayer delivers to the seller a nonrecourse note that is equal to or less than the fair market value of the asset acquired.[156] As distinguished from the total sham transaction, application of the likelihood-of-payment rationale indicates that it is reasonable to assume

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153. The position opted for here, that, despite the presence of a cash payment, basis should be zero where a nonrecourse debt exceeds the fair market value of the asset acquired, should be limited to those acquisitions that require the buyer to apply all income produced by the asset to discharge the debt. Where the buyer is not so obligated, he has acquired, in addition to tax reduction, an economic benefit, the use of the asset and the income it produces until the maturity of the note, at which time forefiture will occur. In such situations, the taxpayer, being motivated by economic objectives to the extent of the fair market value of the asset's income stream during the term of the note, should be entitled to a basis equal to the fair market value of such income stream — in no event, however, should basis exceed the cash payment. The balance of the cash payment is, in essence, a fee for securing tax reduction and should be disregarded as a sham.

It is possible, however, that a taxpayer who acquires an asset for cash and a nonrecourse note that runs afoul of the likelihood-of-payment analysis would be entitled to a basis greater than zero even where the transaction does not provide the taxpayer with an income stream. This would occur where a portion of the cash payment is attributable to the price of securing an option to buy the encumbered asset. For example, assume a taxpayer purchases an asset with a value of $300 by delivering a nonrecourse note in the amount of $400, payable one year from the date of purchase (with all income generated by the asset prior to the maturity date of the note payable to the obligee), and $100 in cash. After applying the sham doctrine and the likelihood-of-payment analysis, it would appear that the taxpayer's basis for the asset should be zero. However, if the value of an option to purchase the asset for $400, which is the face amount of the nonrecourse note during the one-year period commencing on the day the transaction is entered into, has a value of $50, the taxpayer's basis should be $50. Since the taxpayer has acquired an asset, the option with a value of $50 from the seller, to that extent the taxpayer is economically motivated and should not be subject to the sham doctrine.

154. As a consequence, the penalty provided for in I.R.C. § 6659 should apply to the entire underpayment resulting from the reduction of basis to zero. For a further discussion of the penalty, *see* note 107 *supra.*

155. If the taxpayer agrees to pay the inflated price by reason of a mistake, the cash payment would be motivated by economic objectives and should be reflected in basis. The nonrecourse note should, nevertheless, be excluded from basis, inasmuch as mistake is irrelevant in the context of the likelihood-of-payment rationale. *See* text accompanying notes 103-07 *supra.*

156. The nonrecourse note contemplated is one that does not run afoul of the likelihood-of-payment rationale.

that the taxpayer will pay the entire purchase price, including his obligation on the nonrecourse note, and thereby accomplish the business objective of retaining the asset. In this situation, if the taxpayer overpays, the sham doctrine will only preclude the inclusion of the overpayment in the basis computation — the taxpayer's basis will equal the fair market value of the asset acquired. Only a portion of the transaction, the overpayment, is deemed a sham, because, to the extent of the asset's fair market value, the transaction is economically motivated. In essence, the transaction is capable of division into two portions: 1) to the extent of the asset's fair market value, the taxpayer is economically motivated by his desire to acquire the asset and should be entitled to a basis equal to fair market value, and 2) the overpayment, motivated solely by tax-avoidance objectives, is disregarded for tax purposes as a sham.

For example, assume a taxpayer purchases an asset with a value of $100 by delivering to the seller a $100 nonrecourse note (with a fair market value of $100) and $50 in cash. Each of the two components of the consideration package delivered by the taxpayer is supported by a separate purpose: 1) $100 of the consideration furnished by the taxpayer is motivated by a business objective, the taxpayer's desire to acquire the asset, and 2) $50 of the consideration furnished by the taxpayer, which represents an overpayment, is motivated solely by the taxpayer's desire to obtain tax reduction.[157] Thus, this transaction constitutes a partial sham — the overpayment is disregarded as a sham, and the balance of the consideration furnished by the taxpayer, paid in furtherance of a business objective, is reflected in basis, which is, therefore, equal to $100.

This notion, that, regardless of any cash payment, the sham doctrine will always produce a basis of zero where a nonrecourse debt issued in the transaction runs afoul of the likelihood-of-payment rationale, should have been applied in *Morris*. As indicated, the taxpayer in *Morris* purchased a motel subject to a debt that was substantially in excess of the motel's fair market value. In addition, the taxpayer delivered to the seller $25,000 in cash. Finding that tax avoidance was the sole motivation for the overpayment, the court properly invoked the sham doctrine. The court, however,

157. It is assumed that the overpayment is not the result of a mistake or a desire to obtain some other asset or benefit.

held that basis was equal to the fair market value of the motel. This holding would appear to be erroneous: the transaction was a sham in its entirety because the nonrecourse debt was substantially in excess of the motel's fair market value; the basis should have been zero.[158] This is not to suggest, however, that the court's analysis is necessarily inconsistent with the conclusions opted for here, for the Government, not the taxpayer, argued that basis should equal the motel's fair market value.[159] Perhaps, in the absence of such an argument, the court would have held the taxpayer entitled to a basis of zero.[160]

In each of the authorities analyzed thus far that applied the sham doctrine in the basis computation context, the overpayment was made to a party who was related to the taxpayer. The presence of such a relationship in each case presumably facilitated the holding that the transaction was a sham. Indeed, in each case, the claim to an inflated basis was supported by the mere withdrawal by the taxpayer of money from one of its pockets and the simultaneous deposit of the same amount in another of its pockets. The question now posed is whether the doctrine is dependent on the presence of such a relationship.

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158. The entire amount of the nonrecourse debt should have been excluded from basis by reason of the likelihood-of-payment rationale. The cash payment of $25,000 should also have been excluded under a sham analysis. *But see* note 153 *supra*.

159. 59 T.C. at 32. *See also* the Government's position in Marcus v. Commissioner, 30 T.C.M. (CCH) 1263 (1971); Gibson Products Co. v. United States, 460 F. Supp. 1109 (N.D. Tex. 1978), *aff'd*, 637 F.2d 1041 (5th Cir. 1981). The diffidence of the Government is understandable since, at that time, commentators as well were of the view that basis should equal fair market value, even where it is somewhat less than the amount of the debt. *See* Adams, *supra* note 9, at 165; Del Cotto, *supra* note 9, at 73. Indeed, Congress manifested a similar view, enacted in I.R.C. § 752(c). *See* McGuire, *supra* note 9, at 439.

160. The conclusion that basis should have been held to equal zero presents an interesting question: if the value of the motel eventually increases beyond the amount of the encumbering liabilities, should the taxpayer be permitted to include the $25,000 cash payment in basis for purposes of computing gain? While this question is a nettlesome one, it is suggested that the taxpayer should not be permitted to reflect the cash payment in basis. Indeed, the cash payment, it has been argued, was not made for the purpose of acquiring the asset. Rather, the sole purpose for the cash outlay was to structure an artifice that would yield tax savings. As such, the cash expenditure should be viewed as a fee for arranging the transaction as opposed to a cost of acquisition. While this result may seem harsh, the alternative solution, to allow the cash investment to be reflected in basis for purposes of gain computation, while excluding it from basis for purposes of the depreciation deduction and the investment tax credit, would be inconsistent with I.R.C. § 167(g), and § 168(a). *Compare* I.R.C. § 183(b)(2).

In *Thompson v. Commissioner,*[161] a trust company, located in the Bahamas, purchased all of the outstanding shares of a shell corporation for $750. Shortly thereafter, the trust company made a contribution to the capital of the corporation in the amount of $650,000. The corporation then purchased a parcel of real estate for $700,000 by delivering to the seller a note, secured by the real estate, in the same amount.[162] Within three months after the corporation purchased the real estate, the trust company sold 98%[163] of its stock in the corporation to a group of investors for $6,800,000. The investors paid the trust company by delivering to it unsecured promissory notes, bearing interest at the rate of 10%, in the amount of $6,800,000. Within a few months after the investors purchased the stock, they made an interest payment to the trust company in the amount of $475,000. The Internal Revenue Service disallowed the interest deduction claimed by some of the investors on the theory that the note given to the trust company constituted a sham.[164]

In sustaining the disallowance, the court indicated its approval of the Tax Court finding that "a purchase and resale [of the corporate stock] within 3 months at a tenfold increase in price strains reasonable credulity."[165] Having determined that the investors substantially overpaid for the stock, the court held that the notes and the interest payments should, by virtue of the sham doctrine, be disregarded for tax purposes.[166] The predicate for invoking the doctrine was the court's tacit conclusion that the overpayment was motivated solely by tax-reduction objectives.[167]

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161. 631 F.2d 642 (9th Cir. 1980).

162. In addition, the corporation gave the seller $650,000 in cash: $280,000 of this amount represented prepaid interest on the note at the rate of 10% for a period of four years; the balance of $370,000 represented an advance fee for the arrangement of mortgage financing, with respect to the construction of a shopping center and apartments upon the parcel, which the seller agreed to help secure. *Id.* at 644.

163. The actual percentage of stock sold was 98.583%. *Id.*

164. The sham doctrine analysis should be the same, regardless of whether it is an interest deduction or a basis computation that is in issue.

165. Thompson v. Commissioner, 66 T.C. 1024, 1051 (1976).

166. *Id.* at 1050.

167. While the court did not explicity state that the overpayment was motivated solely by a desire to accomplish tax avoidance, the court, before invoking the sham doctrine, indicated that a sham transaction is one that has no "economic effect other than the creation of income tax losses." 631 F.2d at 646. Also, the court suggested that the interposition of the trust company between the owner of the real estate and the investors, which was the mechanism utilized in order to create the inflated purchase price and the investors' notes, was

What is particularly interesting is that the notes, which were held by the court to constitute shams, were recourse in nature, and, while the court was suspicious of a relationship between the taxpayers and the others involved in the transaction, no evidence of such a relationship was before the court. In these circumstances, it appeared that the economic cost incurred by the taxpayer in acquiring the corporate stock was the entire purchase price of $6,800,000. Indeed, unless there was some arrangement between the taxpayers and the others that would require reimbursement, the interest deduction in dispute represented an out-of-pocket expense incurred by the taxpayers in the amount of $475,000. Recognizing that the notes were recourse and that the taxpayers had apparently sustained an out-of-pocket expense, the court had difficulty in reaching its conclusion that tax-reduction objectives were the sole motivation for the overpayment. The court resolved this difficulty by utilizing its finding of a substantial overpayment to infer the presence of a relationship between the taxpayers and the others participating in the transaction. In the absence of such a relationship, the court apparently reasoned, a prudent taxpayer would not agree to an overpayment. Having made this inference, the court was obviously more comfortable with its decision to invoke the sham doctrine.

The presence of a substantial overpayment should not, however, inexorably lead to the inference that the taxpayer is related in some manner to those with whom he is transacting business. Nor should such an inference be an essential predicate for invoking the sham doctrine. As indicated, it is feasible for a taxpayer to realize a profit by overpaying in connection with the acquisition of an asset — the tax reduction that would be generated by the overpayment and the interest income produced by the tax savings can exceed the amount of the overpayment — even if the overpayment is made to a stranger and will, therefore, not be recouped by the taxpayer.[168] Such overpayments, supported by no motivation other than the desire to secure tax reduction and related interest income, should, under the sham doctrine, be disregarded, despite the absence of a relationship between the taxpayer and the seller.[169]

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done "in order artificially to create tax deductions." *Id.* at 647.

168. *See* text & accompanying notes 51-60 *supra.*

169. Where no such relationship exists, the overpayment will produce an out-of-pocket cost for the taxpayer. The taxpayer, of course, will be willing to sustain this cost if the

Why then did the *Thompson* court think it necessary to infer the existence of a relationship in order to invoke the sham doctrine? Apparently, the court's impression was that the tax reduction and related interest income engendered by the overpayment would not be as great as the amount of the overpayment.[170] Thus, if the taxpayer had not had a relationship or understanding with

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resulting tax reduction and related interest income exceed the amount of overpayment. Where a taxpayer intentionally structures such an overpayment solely in order to secure tax reduction and related interest income, the sham doctrine and its underlying policy considerations dictate disregard of the overpayment. *See* text accompanying notes 127-28 *supra.*

In Rev. Rul. 80-329, 1980-2 C.B. 70, the taxpayer intentionally overpaid for an item and then, upon donating it to charity, claimed a charitable donation (*see* I.R.C. § 170) equal to the inflated price. Although the taxpayer purchased the item from one with whom he did not maintain any relationship or understanding, and, therefore, sustained an out-of-pocket cost equal to the inflated purchase price, the Service properly limited the deduction to the item's fair market value, which, it concluded, was substantially below the taxpayer's out-of-pocket cost. It should be noted that the taxpayer paid the portion of the purchase price that represented the overpayment by the delivery of a recourse note. While the Service does not so indicate, it was, presumably, the taxpayer's assumption that the tax reduction and related interest income which would arise from the overpayment would exceed the amount of the overpayment. *See also* Rev. Rul. 81-149, 1981-21 I.R.B. 5, where the Service ruled that interest on a 50-year recourse note, the delivery of which was motivated solely by tax-avoidance purposes, was not deductible, even though the taxpayer was legally obligated to make the interest payments and there was apparently no relationship between the taxpayer and the holder of the note.

Compare the conclusion of the Service in Rev. Rul. 80-329 *with* Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), where the Second Circuit indicated that in its view a debt to an unrelated party that the taxpayer will be required to discharge, though incurred solely for tax-avoidance purposes, does not constitute a sham. *See* note 50 *supra.*

170. Even if it is assumed that the taxpayers had a marginal income tax bracket of 70% and that the entire overpayment had been deductible in the year in which the transaction was consummated (which, of course, was not the case), the tax reduction and related interest income attributable to the overpayment would probably have been less than the amount of the overpayment. For each dollar of overpayment, assuming an immediate deduction and a 70% bracket, the taxpayers would have generated 70 cents in tax reduction. They would have this 70 cents available to produce interest income for 10 years, the term of the note. At the note's maturity, the taxpayers would be required to pay the trust company the dollar. In addition, of course, the taxpayers were required to pay 10% interest each year during the term of the note, with respect to each dollar of overpayment.

This transaction should be viewed as a loan of 70 cents (for each dollar of overpayment) to the taxpayers at an interest rate of 12.395% (which takes into account the stated interest rate of 10% and what is, in essence, a discount of 30 cents, the difference between the amount the taxpayers received (70 cents) and the amount they were required to repay ($1)). If the taxpayers had not been able to invest the 70 cents at a rate of at least 12.395%, they would have sustained an economic loss as a result of the overpayment. Since interest rates in 1965 were, generally, less than 12.395% (*see, e.g.,* Wall St. J., Dec. 6, 1965, at 3, col.1), the court's implicit conclusion that the taxpayers would have sustained an economic loss by virtue of the overpayment seems appropriate.

the other participants whereby the taxpayers would be entitled to reimbursement of some portion of the overpayment, the taxpayers would have undoubtedly suffered an economic loss as a result of the overpayment. Since neither a mistake nor the acquisition of an additional asset or benefit was present, and since it was not reasonable to assume that prudent taxpayers would knowingly enter into a transaction that would inevitably produce an economic loss, the court, in invoking the sham doctrine, properly inferred the existence of such a relationship or understanding.[171]

In sum, overpayments that are motivated by tax-reduction objectives and, consequently, disregarded under the sham doctrine, occur either 1) in the context of a relationship or understanding between the taxpayer and the other participants in the transaction or 2) where no such relationship or understanding exists, if the taxpayer is able to anticipate that the tax reduction and related interest income inherent in the overpayment will be greater than the overpayment. Any overpayment that falls without the scope of these two categories must be attributable to either mistake or the taxpayer's desire to acquire some additional asset or benefit.

One additional aspect of the *Thompson* court's conclusion warrants comment. The court held that the taxpayers were not entitled to deduct any portion of their interest payment.[172] Presumably, the court was of the view that the transaction constituted a total sham. Indeed, the Tax Court relied upon, although the Court of Appeals did not cite, *Estate of Melcher v. Commissioner*,[173] where the court held that the transaction before it constituted a total sham.[174] One might argue, however, that the transaction structured by the taxpayers in *Thompson* was only a partial sham. That is, the recourse notes delivered by the taxpayers to the trust company as payment for the purchase of the stock should have

171. A similar situation confronted the Tax Court in May v. Commissioner, 31 T.C.M. (CCH) 279 (1972). There, a taxpayer purchased television film rights for $365,000, paying $35,000 in cash and delivering a recourse note in the amount of $330,000. The court, concluding that the transaction offered no economic benefit and was, therefore, a sham, sustained the commissioner's disallowance of depreciation deductions in the amount of $365,000. As in *Thompson*, though there was no finding of an explicit relationship between the taxpayer and the holder of the note, the court inferred a relationship, concluding that "the owners of the films never intended to require [the taxpayer] to pay any such purchase price." *Id.* at 284.

172. 631 F.2d at 648.

173. 29 T.C.M. (CCH) 1010 (1970).

174. *See id.* at 1042-45.

been dichotomized: 1) to the extent of the fair market value of the stock, delivery by the taxpayers of their recourse notes was motivated by economic objectives, the desire to acquire the stock, and should not have been declared a sham; and 2) the portion of the recourse notes that was in excess of the stock's fair market value was the result of the taxpayers' desire to secure tax reduction and should have been disregarded under the sham doctrine. Thus, under this analysis, the portion of the interest payment attributable to the part of the notes supported by economic objectives was properly deducted, while the remainder of the interest payment was properly disallowed.[175]

G. *The Internal Revenue Service Speaks*

In its initial attempt to apply the sham doctrine in a basis computation context, the Internal Revenue Service confused the doctrine with the likelihood-of-payment rationale. In Rev. Rul. 79-432,[176] the taxpayer purchased an "art tax shelter"[177] for a purchase price of $200,000. The taxpayer paid the purchase price by delivering to the seller $30,000 in cash and a nonrecourse

175. In *Melcher,* a taxpayer was interested in purchasing a residence. Instead of purchasing the property directly, however, he caused a corporation that he and his attorneys controlled to purchase the property for $85,000. Shortly thereafter, the corporation resold the property to the taxpayer for $110,000. The taxpayer paid the purchase price to the corporation by delivering a note in the amount of $80,000 and by assuming a mortgage secured by the property in the amount of $30,000. The taxpayer then made a substantial interest payment with respect to the $80,000 note to the corporation. Disallowing the entire interest deduction, the court held that the transaction constituted a total sham. Crucial to the court's holding was its conclusion that the corporation had merely acted as an agent on behalf of the taxpayer in purchasing the property — indeed, it was the taxpayer, the court found, who furnished the corporation with all of the funds it required in order to consummate its purchase of the property. Accordingly, but for the taxpayer's tax-reduction objectives, there was no need to interpose the corporation.

Unlike *Melcher,* however, the *Thompson* court did not make a finding that it was the taxpayers who furnished the trust company with the funds it contributed to the corporation's capital. Had such a finding been made, the total sham analysis, as made by the *Melcher* court, would have been appropriate. Perhaps, however, the court's holding is explainable on the ground that the taxpayers failed to sustain their burden of proof with respect to the government's total sham theory—failed to establish that it was they who furnished the trust company with funds used to make the capital contribution.

176. 1979-2 C.B. 289.

177. The bundle of rights purchased by the taxpayer consisted of: 1) an original master lithographic plate, 2) the right to a specified number of limited edition prints, and 3) common law and statutory copyrights.

note,[178] secured by the "art tax shelter," in the amount of $170,000, bearing interest at the rate of 8%, payable approximately 12 years from the time of purchase. Although all of the interest and principal were not payable until the maturity date of the note, the taxpayer was required to prepay principal and interest to the extent of 50% of the net proceeds realized by the taxpayer from the investment. In making its analysis, the Service determined that the fair market value of the investment package purchased by the taxpayer was $30,000.[179]

The Service held that the taxpayer was entitled to a basis of $30,000.[180] In support of this conclusion, reference was implicitly made to the likelihood-of-payment rationale:

> Rev. Rul. 77-110 . . . and Rev. Rul. 78-29 . . . hold that the liability created by a nonrecourse note given as a part of the purchase price of property cannot be included in the basis of the property where the value of the property cannot be shown at least to approximate the value of the consideration, including the amount of the note. In the present case, because the property securing the note has a fair market value of only $30,000, there is no economic incentive for the taxpayer actually to pay the note to avoid the loss of the property. Thus, under the rationale of Rev. Ruls. 77-110 and 78-29, the amount of the note is not includible in taxpayer's basis.[181]

If the first of the quoted sentences is disregarded, the analysis, insofar as the likelihood-of-payment rationale is concerned, is valid. The difficulty with the first sentence is its focus on a comparison of the value of the asset acquired with the value of the consideration package delivered by the taxpayer to the seller in exchange for the asset. The suggestion that the cited rulings require such a comparison is also vexing. Indeed, both rulings properly require a comparison of the value of the asset acquired with the unpaid balance of the nonrecourse note.[182]

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178. Although the note purported to be recourse to the extent of $70,000, the Service concluded that, as a matter of substance, the entire note was nonrecourse. *See* note 80 *supra*.

179. The Service made this finding despite the presence of two appraisals which indicated that the estimated revenue to be derived from the investment package was approximately $200,000. *See* 1979-2 C.B. 289.

180. Since the Service concluded that the asset acquired did not have a determinable useful life, it held that neither a depreciation deduction nor the investment tax credit was available with respect to this basis of $30,000.

181. Rev. Rul. 79-432, 1979-2 C.B. at 291 (citations omitted).

182. Rev. Ruls. 77-110, 1977-1 C.B. 58 and 78-29, 1978-1 C.B. 62, explicitly rely on the source of the likelihood-of-payment rationale, the *Crane* case. Moreover, both rulings quote

Why, then, did the Internal Revenue Service, in the first of the sentences quoted from Rev. Rul. 79-432, suggest that it is necessary to compare the value of the asset acquired with the value of all of the consideration, including the cash payment, delivered by the taxpayer to the seller? Since such a comparison is required in order to determine whether the taxpayer has structured an overpayment that should be disregarded under the sham doctrine, one must assume that the Service, in limiting basis to the amount of the cash payment, intended to invoke the doctrine. The Service's perception that it was necessary to invoke the doctrine is troublesome, however, for the likelihood-of-payment rationale itself mandated disregard of the nonrecourse note and, therefore, a basis equal to the amount of the cash payment.

Confusing the likelihood-of-payment rationale with a sham analysis led the Service to the wrong conclusion. Properly viewed, the transaction was a total sham. The value of the package of consideration delivered by the taxpayer, consisting of $30,000 in cash and a nonrecourse note in the amount of $170,000, certainly exceeded $30,000, the value of the asset acquired. If this lack of equality in the value of consideration packages exchanged was not attributable to a mistake,[183] or the taxpayer's desire to acquire an additional asset or benefit from the seller, the sham doctrine was applicable. While invocation of the sham doctrine generally results in a basis that is equal to the fair market value of the acquired asset, where the value of the asset is less than the amount of the nonrecourse note it secures, basis should equal zero. This zero basis conclusion is premised on the notion that a taxpayer will not discharge a nonrecourse note that is in excess of the value of the acquired asset. Consequently, such a taxpayer, confronting an inevitable forfeiture of the asset, obtains no economic benefit from the transaction — the transaction is merely a device for providing

from the portion of the Supreme Court's decision in which it is indicated that a nonrecourse debt should be treated as if recourse in nature and, therefore, includable in basis, where the balance on the note is less than the value of the asset securing it. For a discussion of the relevance of cash payments in the context of the rationale, *see* text accompanying notes 4-7 *supra*.

183. The appraisals, which were provided by the sales promotion organization, should have provided the taxpayer with an opportunity to argue that the overpayment was the result of a mistake. *See* Curry v. Commissioner, 43 T.C. 667, 694-95 (1965), where the court concluded that the taxpayer's reliance, in good faith, on an appraisal precluded a finding that the price was inflated in order to secure tax reduction.

the taxpayer with tax reduction. As such, the transaction, including the cash payment, should be disregarded for tax purposes and basis should equal zero.[184]

It is arguable, however, that the transaction did provide the taxpayer with some economic benefit. Until the maturity date of the notes, the taxpayer was permitted to retain 50% of the income generated by the asset.[185] Thus, the taxpayer did secure an economic benefit: the right to receive 50% of the income generated by the asset during the term of the note. To the extent of the value of this benefit, the taxpayer was obviously motivated by economic objectives. Since the sham doctrine only operates with respect to transactions or portions of transactions that are motivated by tax-reduction objectives exclusively and since economic objectives, to the extent of the value of the income stream, were present, it was appropriate to provide the taxpayer with a basis equal to the fair market value of the income stream.[186] The taxpayer's basis, therefore, should have been no more than $15,000 — the fair market of the asset being $30,000, the value of the right to receive 50% of the income generated by the asset for a specific period of time could not have exceeded $15,000.[187]

The failure of the Service to distinguish between the likelihood-of-payment rationale and the sham doctrine, which resulted in an erroneous basis computation,[188] may have been caused by the

184. The cash payment should be viewed as a fee for arranging the sham transaction and should, therefore, be denied tax effect. *See* text accompanying notes 150-60 *supra.*

185. The other 50% of the income generated by the asset was required to be applied to discharge the interest and principal obligation on the note.

186. Basis, however, cannot exceed the amount of the cash payment, since the likelihood-of-payment rationale precludes inclusion of any portion of the nonrecourse note in the basis computation.

187. The difference between the amount of the cash payment, $30,000, and the fair market value of the income stream, should be viewed as a cost incurred in order to secure the tax benefits inherent in the sham transaction. Accordingly, this difference should be disregarded for tax purposes. *See* text accompanying notes 149-60 *supra.*

188. While the Service did not refer to the sham doctrine or suggest that it was necessary to focus on the value of the consideration furnished by the taxpayer in Rev. Rul. 77-110 or Rev. Rul. 78-29—both rulings only applied the likelihood-of-payment rationale and, thus, required a comparison of the fair market value of the asset with the amount of the nonrecourse note secured by the asset—the doctrine should have been applied. In both rulings, the Service concluded that basis was equal to the amount of the cash payment. If the Service had applied the doctrine, however, it would have arrived at a basis, in accordance with the analysis suggested in the text, that would have been less than the amount of the cash payment.

misconception of the court in *Estate of Franklin v. Commissioner*.[189] The court, as did the Service in Rev. Rul. 79-432, blended the two concepts:

> An acquisition such as that of Associates [the partnership of which the taxpayer was a member] if at a price approximately equal to the fair market value of the property under ordinary circumstances would rather quickly yield an equity in the property which the purchaser could not prudently abandon. This is the stuff of substance. It meshes with the form of the transaction and constitutes a sale.
>
> No such meshing occurs when the purchase price exceeds a demonstrably reasonable estimate of the fair market value. Payments on the principal of the purchase price yield no equity so long as the unpaid balance of the purchase price exceeds the then existing fair market value.[190]

In the last of the quoted sentences, the court properly applies the likelihood-of-payment rationale by comparing the value of the asset with the unpaid balance on the nonrecourse note it secures. In the preceeding sentences, however, the court mistakenly makes its likelihood-of-payment analysis by comparing the value of the asset with the purchase price, which in all cases obviously consists of the debt as well as any cash payments.

While, as suggested, focus on the amount of the cash payment is irrelevant in the context of the likelihood-of-payment rationale, the court's holding was not affected by this erroneous analysis, for the taxpayer had not made a cash payment.[191] Since, therefore, the purchase price was equal to the amount of the nonrecourse note, the court's failure to distinguish between these two amounts was inconsequential.[192] However, where a cash payment is present, as in Rev. Rul. 79-432, the likelihood-of-payment rationale should be applied, without taking into account the cash payment, in order to determine whether the nonrecourse note should be included in ba-

189. 544 F.2d 1045 (9th Cir. 1976).

190. *Id.* at 1048.

191. The taxpayer did make a $75,000 cash payment. However, this payment was characterized as interest.

192. In Narver v. Commissioner, 75 T.C. 53 (1980), the court also blended the likelihood-of-payment rationale and the sham doctrine. Indeed, the court, after citing *Franklin* and implicitly alluding to the likelihood-of-payment rationale, discussed cases concerning equality of consideration and mistake, neither of which has any relevance in the context of the likelihood-of-payment rationale—the court should have reached its conclusion that the nonrecourse liability was not includable in basis solely by reference to the likelihood-of-payment rationale. Again, however, the absence of a cash payment rendered the blending of the two concepts inconsequential.

sis. The sham doctrine should then be brought into focus in order to determine whether the cash payment or any portion of it should be included in basis.

The Internal Revenue Service again ruled on a basis issue with sham implications in Rev. Rul. 80-42.[193] There, a limited partnership purchased film exhibition rights from a corporation for 2,000x dollars by delivering to the corporation a nonrecourse note in the face amount of 1,500x dollars secured by the exhibition rights and 500x dollars in cash. The partnership was required to prepay its interest and principal obligations on the note to the extent of 50% of the net receipts derived by the partnership from the distribution of the film.[194] The Service assumed that because the corporation had purchased the film rights for 400x dollars a few months prior to entering into the transaction with the partnership, the partnership could not prove a fair market value in excess of 400x dollars for the rights acquired. The Service also assumed that the partnership agreed to pay more than fair market value for the rights in order to enjoy the tax advantages inherent in an inflated basis.[195]

In concluding that the partnership's basis for the film rights was 400x dollars, the Service relied on the likelihood-of-payment rationale and, implicitly, the notion that a taxpayer who overpays for an item in order to acquire some additional asset or benefit from the seller may not reflect the overpayment in the item's basis.[196] While the Service properly analyzed the former concept, its decision to apply the latter concept resulted in an erroneous basis computation. With respect to the likelihood-of-payment rationale, the Service compared the face amount of the nonrecourse note

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193. 1980-1 C.B. 182.

194. *Id.* at 183.

195. *Id.*

196. While the Service did not explicitly articulate reliance on this notion, its citation of Majestic Securities Corp. v. Commissioner, 120 F.2d 12 (8th Cir. 1941), and New Hampshire Fire Insurance Co. v. Commissioner, 2 T.C. 708 (1943) does confirm the reading suggested. *See* text & accompanying notes 113-25 *supra*. Inasmuch as 1) the overpayment was not attributable to mistake, 2) there was no relationship (no identity of economic interests) between the limited partners and the general partner, who, as the majority shareholder of the seller, was the ultimate beneficiary of the overpayment, and 3) the tax-reduction potential inherent in a cash overpayment is always less than the amount of the overpayment, the only plausible motivation for the partnership to pay 500x dollars in cash for an asset with a value of 400x dollars was the desire to acquire some additional benefit. One might surmise that, in the Service's view, the additional benefit acquired by the partnership was the organizational services rendered by the general partner.

(1500x dollars) with the fair market value of the film rights acquired (400x dollars) and correctly concluded that it was highly improbable that the partnership would discharge such an obligation in order to retain the film rights. Thus, the Service's initial conclusion that the basis computation should not include the nonrecourse debt was sound.

Having decided that the note ran afoul of the likelihood-of-payment rationale, the Service should have recognized that the transaction constituted a total sham[197] and that the cash payment of 500x dollars was a cost of arranging the transaction. This view of the transaction requires the conclusion that the partnership's basis in the film rights should have been zero.[198] On the other hand, it is arguable that the partnership did secure some economic benefit from the acquisition: the right to receive 50% of the income generated by the film rights during the term of the note.[199] To the extent of such economic benefit, the transaction was motivated by economic objectives and should not have been denied tax effect; basis should have been equal to the fair market value of the right to receive 50% of the income inherent in the film rights during the term of the note. On this analysis, the partnership's basis in the film rights could not have been greater than 200x dollars (50% of the fair market value of the film rights), for the partnership's right to receive 50% of the income generated by the film rights until the maturity of the note could not have had a greater value than 50% of the value of the film rights.

Why, then, did the Service conclude that the partnership was entitled to a basis of 400x dollars? The Service's timidity is, perhaps, understandable, inasmuch as the taxpayer had made a cash payment of 500x dollars. This, however, is a misleading view of the transaction, for the partnership did not acquire film rights with a value of 400x dollars; rather, the partnership only acquired the right to an income stream which had a value that was substantially less than the 400x dollars.[200] The difference between the 500x dol-

197. Inasmuch as the taxpayer would be required to forfeit the film rights with a value of 400x dollars upon failing to make payment on the 1500x dollar note, the transaction provided the partnership with no economic benefit and was, therefore, motivated solely by tax-reduction objectives.

198. *See* text & accompanying notes 149-60 *supra*.

199. The partnership was required to apply the other 50% of the income to its obligation on the note.

200. *See* note 153 *supra*.

lars cash payment made by the partnership and the value of the acquired income stream was, in essence, a payment for the arrangement of the sham transaction and should have been disregarded for tax purposes.[201]

In sum, the government has begrudgingly applied the sham doctrine. Rev. Rul. 79-432 and Rev. Rul. 80-42 both present transactions that are appropriate subjects for the doctrine. Nevertheless, the Service, in both rulings, refused to properly apply the doctrine. In Rev. Rul. 79-432, the Service disregarded the nonrecourse note under the likelihood-of-payment rationale and concluded, without any analysis of the sham doctrine, that basis was equal to the cash payment. Again, in Rev. Rul. 80-42, the Service excluded the nonrecourse note from basis by reason of the likelihood-of-payment rationale, but, in failing to apply the sham doctrine, concluded that a greater portion of the cash payment should have been included in basis than was appropriate.[202] Moreover, in *Morris,* the government argued that basis should have been equal to the fair market value of the asset acquired, even though the transaction was a total sham — the transaction provided the taxpayer with no economic benefit — and basis should have been zero. The disdain the government has professed for abusive and overvalued tax shelters is, indeed, belied by the diffidence it has exhibited in its application of the sham doctrine.

Conclusion

There are three contexts in which a taxpayer will purchase an asset at a price in excess of fair market value: 1) where the sole purpose for the overpayment is tax reduction; 2) where there has been a mistake as to value; or 3) where the taxpayer is anxious to secure an additional asset or benefit from the seller.

An overpayment that is motivated solely by tax-avoidance objectives should be excluded, by operation of the sham doctrine, from basis computation. To the extent of the fair market value of

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201. *See* note 153 *supra.*

202. *See also* Hager v. Commissioner, 76 T.C. 759 (1981), where the government again failed to argue that the cash payment should be excluded from basis even though the nonrecourse debt was unreasonably in excess of the value of the encumbered asset. *But see* Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. No. 89 (filed Dec. 7, 1981), decided while this article was at press, where the court utilized the sham doctrine to disregard the entire transaction, including the cash investment.

the acquired asset, however, economic motivation is present, and the sham doctrine should not be applied. Thus, where a taxpayer intentionally overpays for the sole purpose of securing tax reduction, basis should equal the fair market value of the acquired asset.

A different perspective of the sham doctrine is required where a taxpayer utilizes a nonrecourse note substantially in excess of the fair market value of the acquired asset. In these circumstances, it is not merely the overpayment that is lacking in economic motivation. Rather, the entire transaction is induced solely by tax-avoidance objectives, for neither the asset nor any other economic benefit is acquired — inevitably, the asset will be forfeited in a foreclosure proceeding. Such a transaction should yield no tax benefits. Indeed, the cash investment, properly viewed as a fee for the arrangement of a transaction that is a sham in its entirety, should, together with the nonrecourse note, be excluded from basis.

Occasionally, a transaction involving a nonrecourse note substantially in excess of the value of the acquired asset is motivated, to some extent, by economic objectives. This will occur where all of the income generated by the acquired asset need not be applied in discharge of the note. The acquisition is supported by economic purpose, the desire to enjoy the income stream inherent in the asset. Thus, to the extent of the fair market value of the income stream, the sham doctrine should not be applied.

There are, however, overpayments that should not be the subject of the sham doctrine. For example, a taxpayer who overpays for an asset under an erroneous assumption of value is motivated by economic objectives. Since it is economic motivation, and not the desire to secure tax avoidance, that results in the inflated purchase price, the sham doctrine should not be applied. Similarly, where a taxpayer acquires an asset at an inflated price in order to secure some additional asset or benefit, the sham doctrine should play no role in the determination of basis. Although the overpayment should be excluded from the basis computation, it should be treated in accordance with the nature of the additional asset or other benefit acquired.

Thus, the answer to the question posed at the outset — why would a prudent taxpayer make an acquisition at a price in excess of fair market value? — will determine the extent to which the sham doctrine is applicable in the basis computation context and the propriety of including an overpayment in basis.